

Hedge Your Retirement Portfolio Against Risk

Peter Lynch famously said that spending 13 minutes thinking about the economy is a waste of 10 minutes. I generally agree with that sentiment. Investors are far better off focusing on the factors they can control—notably, saving enough, creating a reasonable asset-allocation scheme, and taking care in investment selection—than they are attempting to predict the direction of the economy and the market.

Yet it's also a mistake to turn a blind eye to the threats that could erode the value of your portfolio over the long term, particularly if you're already retired. That might seem counter to the viewpoint that I outlined above, but it's really not. Identifying a risk factor and putting in place a long-term plan to hedge against it is quite different than making big changes to your portfolio so it can benefit from a short-term trend that may or may not materialize. The former is risk management; the latter is market-timing.

It pays to consider these risks before you see them splashed on the front page of every newspaper, because by that time you'll pay a premium to hedge against them. The mania for inflation-fighting instruments in 2008 provides a vivid case in point. Worries about higher prices reached a fever pitch last summer, but by then the key inflation-fighting instruments had been bid up substantially. Investors who bought commodities or, to a lesser extent, Treasury Inflation-Protected Securities, in the first half of 2008 suffered substantial losses in the second.

In this month's issue, I'll highlight some of the key retirement-portfolio risks to stay attuned to, and also provide you with some specific long-term strategies and investment ideas for hedging against them.

The Threat: Longevity

I know—it's odd to call longevity a "threat"; it goes without saying that we'd all prefer to live long, happy, and healthy lives. But reaching a ripe old age brings a corresponding worry: outliving your nest egg. That's a particularly big concern for today's retirees. Not only are they living nearly a decade longer, on average, than retirees 50 years ago, but many also saw their portfolios suffer catastrophic drops during the recent bear market.

Some of the best strategies for managing longevity risk are plain old common sense: taking care with your portfolio-withdrawal rate (and reducing withdrawals during and immediately after a down market), working longer and/or part-time during retirement, and deferring receipt of Social Security benefits until age 65 or beyond.

Holding at least some equities during retirement is another strategy for managing longevity risk: The in-retirement portfolios I featured in last month's issue all included at least a 20% position in stocks, and in some cases a much higher position than that. Although there's no guarantee that stocks will go up over the next few decades—and holding a too-high stock position in retirement can subject your portfolio to undesirable volatility—equities have higher long-run return potential than bonds, whose future returns are often roughly in line with their yields. I've listed some of my favorite stock mutual funds for retirees in the table on Page 3. All have

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Christine Benz,
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high-quality orientations, and their managers favor risk-averse strategies.

There are also a few products designed specifically to help retirees manage longevity risk—notably, longevity insurance. With the most basic types of longevity insurance products, you give the insurance company a lump sum at the outset of your retirement. If it turns out you live well beyond your expected life span (based on actuarial figures), you'll receive a monthly payout at that time. Longevity insurance is a lot like a fixed deferred annuity—your in-retirement payouts are established at the time you buy the contract, but you won't actually receive them until a later date.

The beauty of longevity insurance—or at least the concept of it—is that your investment assets need only last for a finite, knowable period: your retirement years up until a predetermined time when the insurance kicks in. The insurance then provides you with a monthly payment for as long as you live, whether that's 15 months or 15 years. Because most people in the longevity-risk pool won't live long enough to draw their payments—or if they do, they won't be drawing upon them for a sustained period of time—the monthly payment amounts that longevity insurance holders receive at an advanced age are quite high.

The key disadvantage of longevity insurance—and it's a doozy—is that you may fork over a substantial sum to buy it but not live long enough to see any benefits from it. If your longevity policy is set to pay out at age 85 but you only make it to age 83, you won't have any recourse. Some longevity insurance policies include survivor benefits payable to your heirs if you die before you begin receiving payments, but you'll pay for that protection in the form of lower payments. And at the time you buy the product—ideally early in retirement or even before—you're pulling assets out of your retirement kitty that might otherwise be able to grow. (See my interview with financial planner Jason Stewart, which begins on Page 6, for more on these types of products.) In general, longevity insurance makes sense only for those who have a good reason to expect that their

life spans will run far higher than average. Your own good health and a history of longevity in your family are good starting points, but also check out a few online longevity calculators for an estimate of how long you're apt to live.

The Threat: Long-Term Care

Another threat, related to longevity insurance, is the possibility that paying for nursing-home care, assisted living, or home health care will gobble up your entire nest egg. With nursing home care averaging \$200 a day in 2008 (and skilled home health care or nursing care at higher-end facilities or in high-cost geographies costing a lot more than that), it's easy to see that an extended stay in a nursing facility could be ruinous to your investment portfolio.

The best hedge against this risk is long-term care insurance, and that's why I recommend it to many of the individuals I feature in the Portfolio Makeover section of this newsletter. This type of insurance also provides valuable peace of mind if a condition like Alzheimer's disease runs in your family.

All the same, long-term care insurance is not for everyone. Those who come into retirement with less than \$250,000 in assets will almost certainly have better uses for their money than paying premiums for this type of insurance; they may also be eligible for Medicaid if they should need long-term care. (If your portfolio is in this ballpark, consult with an estate-planning attorney to determine whether it's advisable to gift assets or create a trust to pass assets to your heirs.) Meanwhile, those with more than \$2 million in assets may be able to pay for this type of care out of pocket. If your portfolio falls in the middle of that range, however, you're a good candidate for long-term care insurance.

Another crucial question is when to buy long-term care insurance. Insurance professionals often push long-term care coverage at an early age; the premiums are certainly lower, and being younger reduces the likelihood that you would have already encountered a serious health problem that could jack up your premiums. (You'll typically be required to take a physical to obtain coverage.) Bear in mind,

In-Retirement Portfolio Hedges

The Threat: Inflation

Name	Category	Star Rating	Expense Ratio (%)	Comment
Vanguard Inflation-Protected Securities VIPSXs	IB	★★★★★	0.2	Provides straightforward, cheap TIPS exposure.
Harbor Real Return HARRX	IB	★★★★★	0.57	Invests majority of assets in TIPS, but can delve into other bonds.
iShares Barclays TIPS Bond TIP	IB	★★★★★	0.2	Core TIPS fund distributes inflation adjustment as income.
Harbor Commodity Real Return HACMX	NR	NR	0.94	Bond sleeve backfired last year, but it's a long-term winner.
iPath DJ-AIG Commodity Index DJP	NR	★★★★★	0.75	ETN provides broad, inexpensive basket of commodities.
Elements S&P CTI ETN LSC	NR	NR	0.75	Long—short fund could hold up better in commodities downdrafts.

The Threat: Higher Interest Rates

Name	Category	Star Rating	Expense Ratio (%)	Comment
Harbor Bond HABDX	CI	★★★★★	0.55	PIMCO-run fund has done a great job of staying ahead of Fed.
Metropolitan West Total Return Bond MWTRX	CI	★★★★★	0.65	Opportunistic fund actively manages its duration exposure.
Vanguard Short-Term Bond Index VBISX	CS	★★★★★	0.19	High-quality portfolio insulated against interest-rate shocks.
T. Rowe Price Short-Term Bond PRWBX	CS	★★★★★	0.55	Risk-conscious approach, but delves into corporate bonds.
Loomis Sayles Bond LSBRX	MU	★★★	0.94	Lower-quality sleeve insulates against interest-rate changes.

The Threat: Higher Taxes

Name	Category	Star Rating	Expense Ratio (%)	Comment
Fidelity Intermediate Municipal Income FLTMX	MI	★★★★★	0.38	Research-intensive approach, low costs are key advantages.
Vanguard High-Yield Tax-Exempt VVAHX	MI	★★★	0.15	Fund takes conservative approach to lower-rated munis.
Vanguard Int-Term Tax-Exempt VWITX	MI	★★★★★	0.15	High-quality focus helps in a rough year like 2008.
Fidelity Short-Intermediate Muni FSTFX	MS	★★★★★	0.47	Low-cost fund avoids interest-rate bets.
T. Rowe Price Tax-Free Short-Intermediate PRFSX	MS	★★★★★	0.51	Risk-conscious approach helps it avoid trouble spots.
Vanguard Limited Term Tax Exempt VMLTX	MS	★★★★★	0.15	Conservative fund held up like a champ in 2008.
Vanguard Short-Term Tax Exempt VWSTX	MS	★★★	0.15	Among least volatile of any fund in conservative category.
Vanguard Tax-Managed Capital Appreciation VMCAAX	LB	★★★	0.16	Provides diversification with low expenses, low tax costs.
Vanguard Tax-Managed International VTMGX	FB	★★★	0.15	Tracks EAFE Index but with low costs, low tax burden.

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however, that the average age for entering a nursing home is roughly 80. So, if you buy a policy when you're in your 50s, you could be paying premiums for 20 years or more before you actually use the coverage. As you investigate long-term care insurance, ask your insurance provider to price coverage for someone at your current age as well as for someone who's five years older; that will help you determine how much you're saving by starting earlier. For most people, initiating long-term care coverage in their early 60s strikes the right balance.

While your age is the key factor in determining when to purchase coverage, bear in mind the effect that prevailing interest rates have on the pricing of these policies. Insurance companies pay claims with a combination of premiums and the interest they earn on those premiums. With interest rates on conservative investments as low as they are now, it's probably a pricey time to buy a policy.

Finally, if you've decided to purchase long-term care coverage, it's important to do your homework to identify the right type of plan from a high-quality insurer. Seek out a broker who specializes in selling this type of product and can help you do an arm's length comparison among different companies. The policies typically don't cover all of your costs, and you may not be eligible to draw upon them unless you're unable to perform a predetermined number of basic activities, such as bathing yourself, feeding yourself, and so forth. Also, most policies have what's called an elimination period, meaning that you'll have to pay out of pocket for a specified period of time before your insurance coverage kicks in. As you might expect, the policies that carry the most favorable terms for buyers are also usually the most costly. The interview that begins on Page 6 discusses what to look for when you purchase one of these policies.

Last but not least, an insurance company's financial standing is an especially important consideration for both long-term care and longevity insurance. You may not be receiving benefits for 20 years or more, so you'll need to take steps to ensure the insurer is still around and in a position to pay its claims when you begin drawing benefits.

The Threat: Inflation

As I've written many times in the past, inflation is a big drag on anyone on a fixed income, like retirees. Whereas working people may receive salary increases to compensate them for cost-of-living increases, most seniors are drawing upon their portfolios for at least a portion of their income, and rising prices erode the purchasing power of their withdrawals.

In the near term, inflation appears to be well under control in the United States; amid generally falling prices over the past year, some economists have even brought up the prospect of deflation, though few have entertained it seriously. Instead, inflation appears to be a more likely long-term threat, thanks to the confluence of massive amounts of fiscal stimulus and growth in emerging markets. For that reason, I think it makes sense to bolster any portfolio that consists predominantly of fixed-rate investments with a dose of inflation protection.

The in-retirement portfolios I featured in last month's issue staked roughly 20%-35% of their fixed-income weightings in TIPS—to my mind, TIPS are the most cost-effective and efficient inflation protection you can buy. You might also consider commodities with a small slice of your portfolio—roughly 5%-6% at the high end.

Before you layer on additional inflation protection, however, see if you already have any quasi-inflation hedges in your portfolio. For example, emerging markets tend to be heavy on basic-material producers, and they in turn are beneficiaries of higher demand and prices; check your portfolio's exposure to Latin America and developing Asian markets. (Morningstar's Instant X-Ray tool is a good way to investigate your portfolio's geographic exposure.) Also look at your portfolio's stake in energy stocks. They're not the same as owning commodities directly, but they have a fairly high correlation with energy prices, and energy is a major component of most commodities indexes.

Stocks are another, indirect way to gird your portfolio against the threat of inflation. They have the potential for higher returns than bonds, and inflation will take

a smaller bite, in percentage terms, out of your future purchasing power. Owning companies with a demonstrated history of dividend growth is another way to help offset the effects of inflation on your portfolio. My colleague Josh Peters' newsletter, *Morningstar DividendInvestor*, focuses on such firms, as do mutual funds like **Vanguard Dividend Growth** VDIGX and the ETF, **Vanguard Dividend Appreciation** VIG.

The Threat: Higher Interest Rates

The Federal Reserve has indicated it will keep interest rates near zero for the foreseeable future, so there's certainly no need to panic about rates heading up any time soon. And for income seekers, the potential for higher interest rates is no doubt a tantalizing one.

For holders of longer-duration bond mutual funds, however, higher interest rates can result in significant volatility. That's because the availability of newer bonds with higher interest rates attached to them leads investors to dump older, lower-coupon bonds, especially longer-dated ones.

It's usually a mistake to get too fancy trying to time the direction of interest rates. But regardless of the interest-rate climate, I favor intermediate-term bond funds over those that focus exclusively on longer-maturity bonds. Unless they have "intermediate term" in their names, funds that land in Morningstar's intermediate categories tend to be more flexible than long-term funds. By outsourcing to a proven intermediate-term manager like PIMCO's Bill Gross, you're giving the manager the latitude to determine your bond portfolio's rate sensitivity. And over long periods of time, intermediate funds' returns have been only slightly lower than long-term bond funds, but volatility, as measured by standard deviation, has been half as high.

The Threat: Higher Taxes

Given the massive amounts of government spending over the past decade, as well as the financial bind many state and local governments find themselves in, it's not at all farfetched to assume that taxes will go up in the future. Taxes may seem like one of life's inevitabilities, but you actually exert quite a lot of control over your investment-related taxes.

If you have bonds in your portfolio, use the Tax-Equivalent Yield tab of Morningstar's Bond Calculator (found on the Tools cover page of Morningstar.com) to determine whether your aftertax yield is higher with a municipal-bond fund than it is with a taxable fund of comparable credit quality and maturity. If tax rates go up, munis will be even more advantageous. Municipal bonds aren't the screaming buy they were in late 2008, but they may still be a better buy for you than taxable bonds in your taxable account.

Many stocks and stock funds are still in the red over the past five years, so if you haven't done so already, it pays to scout around for holdings in your portfolio that you're holding at a loss; you can use those losses to offset capital gains or even ordinary income in the future. Many mutual funds also have big tax-loss carryforwards on their books that they can use to offset future gains. On Morningstar.com, click on a fund's Tax tab to see its Potential Capital Gain Exposure. If the number is hugely negative, the fund may not pay out any capital gains for several years.

To further hedge against the possibility of tax increases, I'm also a big fan of anything that receives Roth treatment—meaning you pay taxes at today's rates in exchange for no taxes upon withdrawals. As I've often written in the past, the fact that anyone can convert their traditional IRA to a Roth in 2010 is a huge gift to anyone who's concerned about taxes. While conventional wisdom had been that you need to be young to make a Roth conversion worth your while, even retirees who expect to live another 15 or 20 years may find a Roth to be a good idea. This is particularly true for affluent retirees who don't expect to need their IRA assets in retirement. Unlike traditional IRAs, Roths don't require mandatory withdrawals, meaning that you can pass those assets to your heirs. ■■

Are Longevity and Long-Term Care Insurance Right for You?

Expert Q & A | Christine Benz

Retirement planning is complicated largely because you're making decisions based on unknown factors—namely, how long you'll live and how healthy you'll be. To help discuss products geared toward mitigating longevity and long-term care risk, I recently sat down for a conversation with Jason Stewart, Vice President of Administration at Cohen Financial Services in Overland Park, Kansas.

Christine Benz: Let's start with a general question: What are strategies you would recommend for someone who is concerned about depleting prematurely the money they've saved for retirement?

Jason Stewart: The main thing we do with a client who comes in and is concerned about that is to break down the assets they currently have, using a retirement income needs analysis. We determine how much they have with a pension—and as we know, the number of pensions have been dwindling over the years—and their Social Security. Then we look at the other assets they've accumulated throughout the years, in 401(k)s, IRAs, and other personal assets they've accumulated. By doing so, we can come up with an idea of how much they're going to have and do a projection using a somewhat conservative interest-rate assumption.

How do you help someone figure out how much income they'll actually need, and whether they'll have enough?

We look at what they currently have, project out what kind of growth they're going to have over the years, and in turn determine what kind of withdrawal rate they want to use. As you know, from all of the Monte Carlo simulations that have been out for years and years, 4% typically is a very safe withdrawal rate based upon stock/bond ratios. We ask them, if they have X amount of dollars and they're withdrawing at 4%, would they feel comfortable

relying on that amount to sustain their lifestyle when they retire?

For some people, 4% is the magic number, but some are going to need more than that. And when they do need more than that, that's when we need to supplement their income with some sort of product to make sure they don't run out of money.

Are you running into a lot of people whose expectations are unrealistic given the hit that their portfolios took over the past year?

We are running into a lot of individuals for whom that is the case. 2008 was not forgiving for anyone—you and I can look at both of our portfolios and vouch for that—and one of the things we want to do is make sure we put some mechanism in place that will allow them to have some sort of income down the road. A lot of people are changing their lifestyles. A lot of people are expecting to work longer than they thought they would. There's also been a big push not only on the corporate side but on the personal side, of individuals deleveraging what they have. A lot of people had a lot of credit card debt. They're now tightening up their belts and budgeting a lot more conservatively, trying to reduce their debt.

It's very disconcerting because many individuals who have lost a substantial amount of money were on the cusp of retiring. They know they're not going to

get it all back in one year, even though the second quarter was spectacular. It's going to take some time for them to recoup what they lost in 2008.

Let's talk about longevity insurance. There's a lot about this concept that's very intriguing for someone who is trying to determine whether their money will last throughout retirement, because it really tackles the unknowable—you don't know whether you'll live to be 95. So in general, what is this product, and what does it seek to achieve?

Longevity insurance has been around longer than people realize. It's coming to the forefront due to the Great Recession. In its essence, this is a single-premium deferred annuity. You're putting a certain amount of money down, at a certain age, knowing that when you turn 80 or 85, you're going to get a guaranteed monthly income for the rest of your life. Typically this is for someone who's getting ready to retire—people in their mid-50s out to age 65. That is the target market for longevity insurance.

Can you provide a sense of what the payouts are like once you reach the target age?

Putting \$50,000 to purchase this at the age of 55, beginning at age 85—and this is for a male—you're going to generate roughly about \$75,000 a year at age 85. If this same male purchased it at age 60, you're looking at about \$56,000 at age 85. If you waited to purchase the insurance at retirement age, at 65, you're looking at about \$41,000 a year. Females tend to receive a little less.

put X amount of dollars in here and not be able to get a hold of it for 20 to 30 years down the road." You can set it up so that beneficiaries receive some of the money in case you don't make it to 80 or 85. But the numbers that I just gave you reflect pure longevity insurance—if you don't make it to 85, the insurance company gets the money. I would never condone that with any of our clients. If they're going to put their money into something like this and it's going to extend out for 20 to 30 years, there's no question that if they pass before they're age 85, we want to make sure that their heirs receive a benefit.

So what type of profile would someone fit for you to recommend longevity insurance to them?

I would primarily look for someone who is nearing retirement or in retirement. If they are taking out around 4% and they've got a great asset-allocation structure, I wouldn't worry about it. But if someone is 65 years old and they're looking to take out a certain amount that is well above their optimal withdrawal rate, it's something that we're definitely going to discuss with them.

But it's also age-dependent. If I have an 89-year-old client who's taking out 6% or 7% and they have plenty of money, I'm not going to worry about it as much. Plus, trying to buy longevity insurance at that age is going to be astronomical.

And would you ask about personal health history, family health history?

I would ask about the personal health history, I would ask about the family history. That is usually a good indicator in some instances of what their life expectancy is going to be. We do that anyway with regular life insurance; we would do it with longevity insurance as well.

I was wondering whether it's possible for someone to implement this same concept of longevity insurance themselves—and do it on an individualized basis—essentially say, well, I'm going to put the money away, invest it in something super-safe, perhaps zero-coupon bonds plus some measure of inflation protection. What do you think about that idea?

“...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.'”

So how much of one's portfolio would go into such a product? And what are the drawbacks?

If you're looking at some sort of longevity insurance, you usually want to put anywhere from 10% to 15% of your portfolio into a product like this. The big concern that people run into is, "I'm going to

If they're doing it themselves, I would think that would be a good approach. The pros of that are this: you're doing it yourself, and you have control of the money. The other way, you don't have control of the money. However, by going with longevity insurance, you know that you're going to get X down the road and you don't have as much of the market fluctuation that you possibly could have with zeros and with TIPS. You have interest-rate risk involved with those bonds, of course. Earlier in 2008, Treasuries were the way to go. Now you look at the first two quarters of this year and that's not the case. The question is, what's your risk tolerance if you want to do it yourself? If you feel comfortable with that, by all means go that avenue. If you do not feel comfortable with that, and you think this might be an avenue you want to take, then certainly seek somebody out and go with the longevity insurance.

That's something we haven't touched on but obviously, that's a huge appeal with longevity insurance as well. Many people think, "Well, I do think I can avoid running out of money for my own retirement, but it's very important for me to leave something for my children and grandchildren."

Once you bring in a question about leaving something to your heirs or having some sort of legacy, that changes the whole scope of things. It doesn't matter how much they have; long-term care insurance, or longevity insurance, for that matter, is a vital portion.

And what's the right age to consider buying long-term care insurance?

With long-term care policies, it's primarily the same demographic as with longevity insurance, people who are nearing retirement or people who are 10 years out from retirement, so people in their 50s or 60s. Some clients want to buy it earlier—even in their late 40s—after they've had to help a parent, or the parent has lived with them, or the parent has just moved into some sort of home health care.

But it seems like late 40s is really young to be purchasing this given that the typical age you would begin tapping it is 80 or 80-plus. So you're paying into the policy for 30-odd years. Of course your premiums would be lower, but still.

It does seem young, though I have a client who decided that's what she needed. Our personal opinion is that long-term care insurance is most appropriate from the middle 50s up until you're getting ready to retire at 65 or so. The reason the 40-something popped into my head was that I had an individual who came in at that age and said, "I really need to look into some long-term care insurance." And for individuals like that, I would possibly look at a different avenue of premium structure, perhaps like a 10-payment situation.

So what other questions should you ask when considering one of these policies?

The typical policy involves paying premiums every single year, but I will preface that by saying you want to find a policy that will maintain that same premium level for the same level of benefit that

“Some clients want to buy it earlier—even in their late 40s—after they've had to help a parent, or the parent has lived with them, or the parent has just moved into some sort of home health care.”

In contrast to longevity insurance, long-term care insurance is pretty familiar to most people. What kind of asset level would someone have for you to recommend that type of insurance?

Primarily people who are in that middle class level should consider long-term care. People who don't have much money—those with, say, \$200,000 or less, are going to drain it out quickly and will be on Medicaid. With \$1.5 to \$2 million and up, many individuals will be able to self-insure. But individuals with assets between \$200,000 and \$1.5 million are good candidates.

We also see a lot of individuals with over \$1 million who opt for long-term care insurance because they want to make sure that they have something for their heirs.

you're going to get. There are some long-term care companies that will raise the premiums, the older you get, to maintain the same level of benefit.

That's one of the questions that a client should ask the insurance company, or if they're going through an agent, they should ask, "Are my premiums going to increase at any point in time? Which products allow for me to pay a level premium and I don't have to expect any sort of rate increases?"

We had an individual who was 77 years old and has had a long-term care policy for years. She has not had to use it because she's in excellent shape, but she got a notice from her insurance company saying that her premium was going up. We reviewed what she had. She had gotten the policy at a much younger age, so you have to do a premium comparison. If she were to buy a new long-term care policy now, how much would it cost compared to the rate increase to continue her current policy? She could also keep her premiums the same but settle for a lower benefit in the future. She said she would rather go with the premium increase, which wasn't that substantial, believe it or not, and continue with the same level of monthly benefit that she'd have if she went into a facility.

So say you're a married couple looking at long-term care insurance. Do you have to buy the policies individually?

There are some policies where you don't have to. There are some that are set up for a husband and wife, to cover both of them for four years, for example. Let's say the husband goes into a nursing facility for a year. When he comes back out, the wife still has the possibility of using that pool for three more years.

It seems like you'd also want to look for flexibility and the ability to receive care in your home versus some external facility.

I just saw a statistic that 20% of claims from long-term care are done in a nursing home; the rest are home health care.

And I assume we'll just see things move more and more in that direction, where people might want and demand that flexibility.

For individuals looking for long-term care, that's a question they need to ask every single time. Because people don't want to move out of their homes. They're comfortable, it's their home, they don't want to have to move into a facility. It's the last thing they want to do. So a key thing to ask is whether you can use the insurance for home health care. ■■■

“You're putting a certain amount of money down, at a certain age, knowing that when you turn 80 or 85, you're going to get a guaranteed monthly income for the rest of your life.”

Let's talk about what kind of features someone should look for in one of these policies. I know you can buy inflation protection, for example. Would you recommend that?

Yes. I will tell you it's going to raise the premium costs up and it does so somewhat significantly, but you need to take into account that we're doing future forward planning on this, and that is something that is definitely necessary. Does it cost more? No question it costs more.

A Little Fine-Tuning Before Retirement

Portfolio Makeover | Christine Benz

Like many readers who write to me seeking Portfolio Makeovers, Mark Petrovich (not his real name) is what Morningstar's marketing department calls a "validator." Now 60, he's been a do-it-yourselfer his whole investing career, relying on the advice of Morningstar and other sources to pull together investments for himself and his wife Fay, 59.

Yet with retirement on the horizon within the next five years, Mark is seeking assurance that he's not missing anything. He had a host of questions for me, including whether his and Fay's asset allocation was in the right ballpark, whether the composition of their fixed-income holdings was appropriate, how much to hold in TIPS, and too many others to list here. Mark also asked for help with streamlining their portfolio. Between his Solo 401(k) (a 401(k) for self-employed people), Fay's 403(b), IRAs, and taxable accounts, the couple has more than 25 individual holdings. Mark would like to have fewer holdings to oversee while also ensuring that their portfolio is adequately diversified. Most important, he and Fay would like to feel confident that their assets will last them through their retirement years.

The Before Portfolio

Mark and Fay have made good choices, not just with their investments but with their finances overall. The couple have saved aggressively and even bought more of their funds when the market went down in 2008. While their portfolio is still a ways from its high-water mark, it remains a robust \$1.4 million. Mark and Fay own their primary residence, valued at \$800,000; their only debt is a \$285,000 mortgage on a Florida condo, which they purchased in 2006 for \$525,000.

Mark has taken great care to research the couple's investment picks, and his hard work shows. Nearly all of their investments are Morningstar's Analyst Picks.

Index funds from Vanguard form the backbone of this couple's portfolio, but they also have some fine active choices, including **PIMCO Total Return** PTTRX, **Fairholme Fund** FAIRX, **Harbor International** HAINX, and **Loomis Sayles Bond** LSBRX.

I also think their asset allocation, albeit aggressive with a roughly 60% stock weighting, makes sense for them. For one thing, longevity should be a real concern for anyone retiring as early as Mark and Fay are contemplating, and stocks offer the best potential for growth. Moreover, the combination of Social Security and Fay's pension will cover nearly all, if not all, of this couple's income needs in retirement. That means this couple needs less stability and liquidity than would retirees who expect to tap their investments more heavily.

The After Portfolio

As good as the Petroviches' finances look, I still think there's room for improvement. For starters, I'd like to see them add more explicit inflation protection. While they own **Vanguard Inflation-Protected Securities** VIPSX, a fine, plain-vanilla TIPS fund, I think TIPS should comprise a higher percentage of their overall fixed-income portfolio—between 20% and 25%. To bolster their TIPS position, they could pull assets from **Vanguard Total Bond Market Index** VBMFX, whose big weighting in U.S. Treasuries could put it at a disadvantage relative to more corporate-bond-heavy funds in the years ahead.

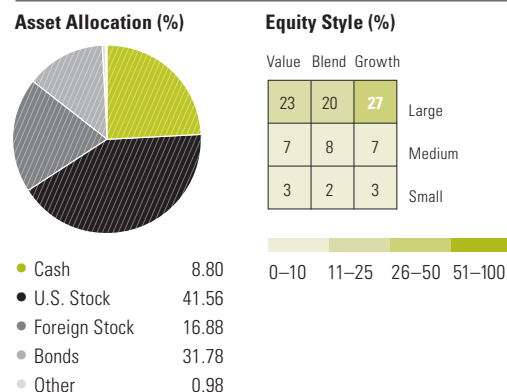
I'd also recommend a dedicated commodities fund to supplant the couple's positions in **Vanguard Energy** VGENX and **Fidelity Select Natural Resources** FNARX; they could consider a traditional mutual fund, such as **Harbor Commodity Real Return** HACMX, or opt for an exchange-traded note like **iPath Dow Jones-AIG Commodity Index** DJP.

In addition, the couple could make some changes to their domestic-equity holdings. **Vanguard Diversified Equity** VDEQX is the largest active equity holding in Mark and Fay's portfolio, but it has been an underwhelming performer since its launch in 2005. Styled as an actively managed version of **Vanguard Total Stock Market Index** VTSMX, this offering is a fund

Petroviches' Portfolio: Before

Fund Name	Star Rating	Category/ Industry	Holding Value (\$)	Expense Ratio (%)
Vanguard Total Bond Market Index VBMFX	★★★★	CI	257,459	0.20
Vanguard Total Stock Market Index VTSMX	★★★	LB	215,933	0.16
Vanguard Diversified Equity VDEQX	★★★	LB	188,389	N/A
Masters' Select International MSILX	★★★★★	FB	136,592	1.07
PIMCO Total Return PTTAX	★★★★★	CI	106,319	0.90
Vanguard Inflation-Protected Securities VIPSX	★★★★	IP	48,327	0.20
CGM Focus CGMFX	★★★	LG	44,780	0.97
Harbor International HAINX	★★★★★	FV	41,377	0.79
Fairholme FAIRX	★★★★★	LB	39,105	1.01
Allianz NFJ Dividend Value PNEAX	★★	LV	27,582	1.04
American Funds Growth Fund of America RGACX	★★★★	LG	27,525	0.91
Vanguard Small Cap Index NAESX	★★★	SB	27,356	0.23
Vanguard Mid Capitalization Index VIMSX	★★★	MB	27,195	0.22
Perkins Mid Cap Value JMCVX	★★★★★	MV	25,271	1.06
Cash	N/A	N/A	47,135	N/A
Total (including 14 holdings not shown)			1,448,470	

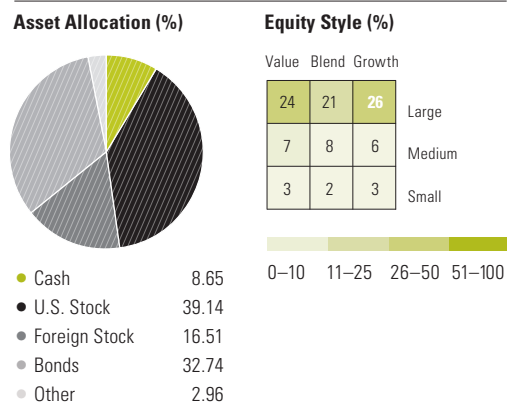
Super Sector Weighting (%)		Top Three Sectors (%)	
Information	19.40	Utilities	16.94
Service	42.55	Financial Svs	12.92
Manufacturing	38.05	Energy	12.49



Petroviches' Portfolio: After

Fund Name	Star Rating	Category/ Industry	Holding Value (\$)	Expense Ratio (%)
Vanguard Total Bond Market Index VBMFX	★★★★	CI	155,787	0.20
Vanguard Total Stock Market Index VTSMX	★★★	LB	215,933	0.16
Vanguard Diversified Equity VDEQX	★★★	LB	75,000	N/A
Masters' Select International MSILX	★★★★★	FB	177,968	1.07
PIMCO Total Return PTTAX	★★★★★	CI	106,319	0.90
Vanguard Inflation-Protected Securities VIPSX	★★★★	IP	150,000	0.20
CGM Focus CGMFX	★★★	LG	44,780	0.97
Fairholme FAIRX	★★★★★	LB	77,494	1.01
Allianz NFJ Dividend Value PNEAX	★★	LV	27,582	1.04
American Funds Growth Fund of America RGACX	★★★★	LG	27,525	0.91
Vanguard Small Cap Index NAESX	★★★	SB	27,356	0.23
Vanguard Mid Capitalization Index VIMSX	★★★	MB	27,195	0.22
Perkins Mid Cap Value JMCVX	★★★★★	MV	25,271	1.06
Cash	N/A	N/A	44,193	N/A
Total (including 12 holdings not shown)			1,448,470	

Super Sector Weighting (%)		Top Three Sectors (%)	
Information	18.53	Financial Svs	17.40
Service	45.98	Health Care	14.60
Manufacturing	35.49	Industrial Matls	12.20



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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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A Little Fine-Tuning Before Retirement Continued from Page 10

of funds. But several of the underlying holdings, such as **Windsor** VWNDX, **Capital Value** VCVLX, and **U.S. Growth** VWUSX, have had manager changes in recent years. I'd reduce its importance in their portfolio and plow the assets into higher-conviction names such as **Vanguard Dividend Growth** VDIGX and Fairholme. Nor am I a fan of **CGM Focus** CGMFX, an extraordinarily volatile, go-anywhere fund, in the portfolio of someone who's getting ready to retire. The couple's position in the fund has dropped by more than half since they bought it; that, plus the fact that its manager is talented, makes me inclined to suggest that they hang on for now but sell after it has rebounded somewhat.

I also think that Mark and Fay could streamline their international holdings. They own **Fidelity Spartan International Index** FSIX, which tracks the MSCI EAFE Index, as well as active funds **Harbor International** HIINX and **Masters' Select International** MSILX. While both the Harbor and Masters' funds are terrific offerings, the Harbor managers run a sleeve of the Masters' fund, making the Harbor fund redundant.

In addition to these portfolio changes, I would also recommend that the couple consider paying down the mortgage on their condo aggressively over the next few years, to further reduce their expenses once they do retire. They should also investigate long-term care insurance because their current ages and portfolio level put them in the sweet spot for obtaining this type of coverage. ■■

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