

## Does Your Retirement Portfolio Need a Moat?

Investors who are in or nearing retirement face a conundrum. On the one hand, increased longevity means that holding stocks is a must for most retirees. Without the growth potential that equities afford, the risk of outliving your assets is simply too great. On the other hand, 2009's market debacle amply demonstrated the havoc that stocks can wreak on retiree portfolios. If your portfolio incurs big losses before or during retirement, the net result might not be just sleepless nights but also a meaningful change in your standard of living.

Because your asset allocation is such a big determinant of how your portfolio behaves, finding the right stock/bond/cash mix is the most significant investment decision you'll make, no matter what your life stage. Not only should the size of your portfolio play a role in the asset-allocation decision-making process, but also whether you have income from other sources, your ability to withstand losses (would portfolio losses of a certain magnitude require you to reduce your spending?), and your desire to leave a legacy for your loved ones.

Assuming you've decided to carve out a portion of your portfolio for stocks, however, the *type* of stocks you choose will also have an appreciable impact on your portfolio's return potential, as well as its potential for losses. True, 2008 might have seemed like the kind of market environment when stock investors simply couldn't win: Stock types that retirees may have assumed to be less risky, including dividend

payers, large- and mega-caps, and value-oriented names, all tumbled at once.

When viewed through another lens, however, 2008 was very much a tale of two stock markets. And while it wasn't possible to avoid losses entirely, it would've been possible to dramatically reduce them by adding another tool to your stock- and fund-picking arsenal. Companies with what Morningstar's stock analysts call moats—in short, defensible franchises and sustainable competitive advantages—clearly held up better than no-moat companies last year. By extension, mutual funds that held wide-moat companies also posted much smaller losses than funds with no-moat or narrow-moat firms. The graphic on Page 5 provides a vivid illustration. No-moat companies lost close to 50% in 2008, whereas wide-moat firms lost 20 percentage points less.

That trend has reversed itself thus far in 2009. As investors embraced risky assets again, narrow- and no-moat firms have trounced wider-moat companies, as evidenced by the illustration on Page 5.

That zig-zag 2008/2009 performance pattern argues for maintaining some exposure to both types of companies if you want to be truly diversified. Nonetheless, you're still far better off avoiding losses in the first place than trying to make them up after a downturn. And needless to say, loss avoidance is particularly important for those who are already in retirement and may not have years and years to wait around for their portfolios to recover. For example, the investor who lost 49% by holding no-moat stocks in 2008 would have to see his portfolio double in value during a recovery just to get back to break-even. The wide-moat investor who had lost 28% in

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Christine Benz,  
Director of Personal Finance

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2008 would have his work cut out for him, too—losing a fourth of your portfolio is nothing to sneeze at—but he'd have to gain a much smaller percentage in a recovery to get back to break-even.

It's also worth noting that wide-moat stocks currently appear to be undervalued relative to no-moat companies. Thanks to the latter's recent outperformance, Morningstar's stock analysts believe low-quality stocks are roughly 15% overvalued, based on their estimates of companies' price/fair value ratios. Wide-moat companies, in contrast, are roughly 15% undervalued, according to our analysts' estimate. (These data are as of early September.) So if you have cash you've been waiting to deploy into equities but are concerned about buying after six months' worth of rally, wide-moat stocks and funds could prove to be a very good way to go about it.

### **Moats and Why They Work**

For these reasons, I strongly believe that retirees can help their own cause by skewing the equity components of their portfolios toward wide-moat firms. True, all bear markets are different, and it's a mistake to assume the patterns we saw during 2008 will hold true in future downturns. For example, smaller-cap and value names strongly outperformed large-cap growth stocks during the 2000-02 bear market, but that wasn't the case in 2008. (Our stock analysts weren't assigning moats to every company they covered during the bear market earlier this decade, so it's not possible to examine the performance of wide-moat versus no-moat stocks during that downturn.)

But just as it's easy to understand why investors gravitate to Treasury bonds when they're worried about the future, it's also easy to see why wide-moat companies hold up better than narrow- or no-moat companies in times of economic turmoil. Simply put, the strong get stronger during tough economic environments, and wide-moat firms have generally shown a consistent ability to earn a return on invested capital that's higher than their cost of capital.

Wide-moat firms hail from a variety of market sectors. But, typically, companies with what our stock analysts call wide moats have one of the following characteristics, and many wide-moat firms have more than one of these qualities.

**Huge Market Share:** When a firm enjoys economies of scale in areas like manufacturing, sales, and marketing, that can be a strong competitive advantage. **Wal-Mart** WMT is a good example of a company that enjoys an economic moat due to its size. As the world's largest retailer, the company can negotiate favorable terms on everything from the products on its shelves to store leases and distribution agreements.

**Low-Cost Production Capabilities:** The ability to produce and sell products or services at a lower cost than competitors is an advantage that's especially potent in commodity industries. Wal-Mart is another good example here. Because its prices are lower than most retailers of everyday goods, it can readily steal market share from higher-cost competitors. That ability was on display in 2008, when strapped consumers traded down from higher-priced retailers.

**Patents, Copyrights, or Governmental Approvals and Licenses:** Some companies generate enormous profits when their products or markets are protected by the government. Pharmaceutical maker **Abbott Laboratories** ABT exemplifies a firm with a wide economic moat as a result of its many patent-protected drugs.

**High Customer-Switching Costs:** If you can make it tough for your customers to use a competitor's product, it's usually easy to keep ratcheting prices up just a bit year after year, which can lead to big profits. **Microsoft's** MSFT wide moat owes in part to high customer-switching costs. Many computers come preloaded with Microsoft software, meaning that consumers have to go out of their way to use another operating system.

**The Network Effect:** This is a relatively rare, but potentially quite potent, source of competitive advantage, and often accrues to the first mover in

## Where the Moats Are

The stocks on this list all have wide moats and low fair-value uncertainty ratings, meaning that our analysts think they have sustainable competitive advantages and stable, predictable cash flows. All of the companies listed here are trading at a substantial discount to our analysts' estimates of their fair values. Price/fair value ratios are based on the most recent Morningstar analysis date; check Morningstar.com for the most current information.

### Stocks

Name	Industry	Price/Fair Value (%)	Star Rating	Comment
<b>Abbott Laboratories</b> ABT	Drugs	0.70	★★★★★	Strong portfolio of patent-protected drugs provides a wide moat.
<b>ExxonMobil</b> XOM	Oil & Gas Pipelines	0.79	★★★★	Operational strength a big advantage in volatile industry.
<b>Johnson &amp; Johnson</b> JNJ	Drugs	0.75	★★★★★	Diverse revenue base, robust pipeline, strong cash flows.
<b>Magellan Midstream</b> MMP	Oil & Gas Pipelines	0.85	★★★★	Likely to deliver strong cash flows in almost any market.
<b>Medtronic</b> MDT	Medical Devices	0.77	★★★★★	Diversified portfolio, ability to innovate are key advantages.
<b>Novartis</b> NVS	Drugs	0.67	★★★★★	Boasts diversified product mix, impressive pipeline.
<b>Procter &amp; Gamble</b> PG	Consumer Products	0.75	★★★★★	Brand-building, product development set it apart.
<b>St. Jude Medical</b> STJ	Medical Devices	0.77	★★★★★	Diversified portfolio, innovation are sustainable advantages.
<b>Stryker</b> SYK	Medical Devices	0.63	★★★★★	Strong product portfolio, high switching costs provide its moat.
<b>Wal-Mart</b> WMT	Retail	0.83	★★★★★	Size allows it to negotiate favorable terms on almost everything.

The funds on this list all have a large share of their portfolios in wide-moat firms; many of them also have a big percentage of their portfolios in companies with low fair-value uncertainty ratings.

### Funds

Name	Category	Avg Weighted Moat (%)	Avg Fair-Value Uncertainty	Comment
<b>Jensen</b> JENSX	Large Growth	2.72	1.33	Profitability focus anchors it in high-quality blue-chip names.
<b>Oak Value</b> OAKVX	Large Blend	2.68	1.74	Little-known, high-quality fund held up well in the bear market.
<b>Dreyfus Appreciation</b> DGAGX	Large Blend	2.64	1.65	Patient, blue-chip-focused fund is an ideal retiree holding.
<b>Bridgeway Blue Chip 35 Index</b> BRLIX	Large Blend	2.62	1.87	Mega-cap portfolio has slight contrarian tilt.
<b>Vanguard Dividend Appreciatn</b> VDAIX	Large Blend	2.60	1.45	High-quality index fund; also available in ETF form (VIG).
<b>Sequoia</b> SEQUX	Large Blend	2.53	1.53	Berkshire Hathaway, plus many other high-quality names.
<b>Marsico Focus</b> MFOCX	Large Growth	2.49	2.25	We're unfazed by recent performance slump.
<b>Vanguard Dividend Growth</b> VDIGX	Large Blend	2.48	1.68	Actively managed fund has performed impressively.
<b>Aston/Montag &amp; Caldwell Growth</b> MCGFX	Large Growth	2.47	1.94	Fund boasts good mix of stable and more rapid growers.
<b>Appleseed</b> APPLX	Mid Value	2.40	2.02	Socially responsible fund uses value-based approach.
<b>Wasatch Heritage Growth</b> WAHGX	Mid Growth	2.18	2.20	Focus on consistent growers reduces downside risk.
<b>Baron Asset</b> BARAX	Mid Growth	2.13	2.06	Lands in volatile category, but practices quality approach.

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an emerging technology. Because a network's value increases as more people use it, the company that creates the network can create a massive economic moat. Our stock analysts point to credit-rating agency **Equifax** EFX as an example of a wide-moat firm that benefits from the network effect. Not only do businesses rely on its reports, but they also provide it with data, leading to a virtuous circle.

### Identifying Wide-Moat Stocks

So how do you find wide-moat companies? If you're a Premium subscriber to Morningstar.com and interested in identifying individual wide-moat stocks, click on the Stocks cover page. Under "All 2,000 Stocks We Cover," click on "Wide Economic Moat." Alternatively, you can use the Premium Stock Screener to help identify wide-moat companies, and you can also layer on additional criteria such as companies with low price/fair value ratios, meaning that our analysts think they're trading cheaply. I also like to look at low fair-value uncertainty ratings, which generally mean that our stock analysts have a high degree of confidence in the predictability of a company's future free cash flows. Our preliminary analysis shows that companies with low fair-value uncertainty ratings, like those with wide moats, dramatically outperformed in 2008.

Here are some individual stocks that look good on all three metrics: wide moats, low fair-value uncertainty ratings, and price/fair value ratios of less than 1.0, indicating that our stock analysts think they're trading at a discount to what they're truly worth.

#### Abbott Laboratories ABT

As I noted before, Abbott's portfolio of patent-protected drugs provides it with a wide moat. Because patent expirations are inevitable for drug firms, however, the firm also has strong lineups in the areas of health-care diagnostics and nutritional products. The stock is currently trading at just 70% of what analyst Damien Conover thinks it's worth, and investors get paid to wait: The company had an above-market dividend yield of 3.4% in late September.

#### ExxonMobil Corporation XOM

Like all energy firms, Exxon is vulnerable to swings in volatile energy prices, but our analysts think the firm's successful pursuit of operational efficiencies will set it apart from other firms within the same sector. Management also has a good track record of allocating capital to the highest-payoff projects. ExxonMobil is currently trading at an 80% discount to analyst Allen Good's estimate of its fair value.

#### Procter & Gamble PG

This consumer-product stalwart has built a wide moat with its product development and marketing prowess, and it has also done a good job of acquiring and integrating competitors with complementary product profiles, as was the case with its Gillette purchase in 2005. Our analyst Lauren DeSanto is also impressed that the firm, which is the largest consumer-products company in the world, has been able to avoid bloat despite its girth, controlling costs and delivering strong per-employee productivity levels. Like Abbott, P&G has a dividend yield that's comfortably above that of the broad market.

#### Stryker SYK

Unlike the above-mentioned firms, medical-equipment maker Stryker didn't hold up especially well in 2008, as reduced hospital spending cut into the firm's sales. However, analyst Julie Stralow particularly likes the firm's orthopedic-implant business, including artificial knees and hips, because the business tends to be sticky: Once a surgeon learns to use a certain type of artificial implant, he or she is loath to make a change. Stryker appears particularly undervalued right now, with a price/fair value ratio of just 0.63.

### Identifying Wide-Moat Funds

Even if you're not a stock investor, you can ensure that your portfolio also has wide-moat stocks. My colleague David Kathman, with the help of quantitative analyst Mark Komissarouk, recently took a look at which mutual funds have the greatest share of wide-moat companies. Here are some of my favorites that are widely available to fund investors. I've mentioned many of them in previous articles, and maintain that they're great choices for retiree portfolios. You'll note that many of these funds haven't

performed particularly well thus far in 2009, but they may also have greater upside potential from here than do funds with more narrow- or no-moat companies.

**Jensen JENSX**

It's no surprise that Jensen consistently shows up on Morningstar's list of the funds with the highest share of wide-moat companies: Management seeks firms that have delivered returns on equity of 15% or better in each of the past 10 years, a feat that would be impossible to pull off without having a sustainable competitive advantage. Whereas this portfolio has historically tilted heavily toward consumer-staple stocks and drugmakers, and still does, management has recently been finding more technology and industrial companies that meet its criteria. Jensen's portfolio also earns a remarkably low fair-value uncertainty rating, meaning that our analyst team has high confidence in the cash-flow-generating abilities of its underlying companies.

**Dreyfus Appreciation DGAGX**

Regular readers know that I'm a big fan of this fund for retiree portfolios. Yes, its year-to-date performance has been underwhelming, and yes, I wish its costs were lower. But apropos for retiree portfolios, this fund's basket of wide-moat stocks has helped it excel on the downside, making it easy for shareholders to hang on during periods of broad-market turbulence. The fund's investor returns, a

measure of what the average shareholder has actually earned here, are higher over the past decade than its published total returns. I'd argue that owes to the fund's low volatility, which has helped keep shareholders from buying high and selling low.

**Sequoia SEQUX**

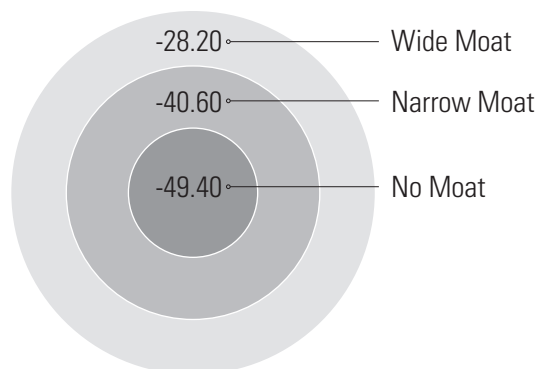
Although Sequoia's average moat rating isn't quite as high as the aforementioned funds, it still towers above most mutual funds. The fund's fair-value uncertainty rating is also very low relative to other large-company funds, indicating our analysts have a high degree of confidence in the cash-flow-generating abilities of its underlying companies. The merits of such a portfolio were on full display in 2008, when it lost fully 10 percentage points less than the S&P 500.

**Vanguard Dividend Appreciation VDAIX**

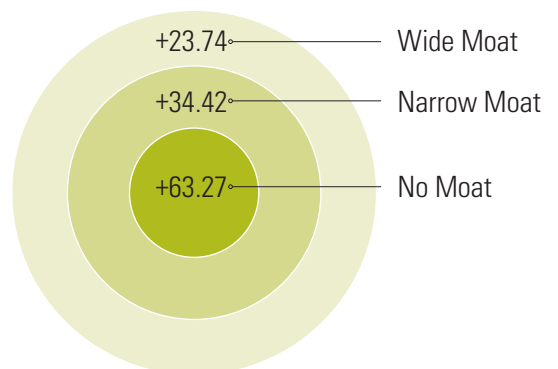
**Vanguard Primecap VPMCX** also has a big share of wide-moat companies, but it's closed to new investors. This fund is a close second on the moat front at Vanguard, however, as its focus on companies with a record of growing their dividends has helped keep the overall portfolio's quality high. Note that its strategy doesn't give it a high dividend yield in absolute terms, but we're still bullish on this fund's prospects and think its very low costs are another big plus. ■■■

A Tale of Two Markets

2008



2009 (through Sept. 25, 2009)



# Teach Yourself to Become a Better Investor

Expert Q & A | Christine Benz

The field of behavioral finance examines the intersection between psychology and economic decision-making. In his fascinating recent book, “Your Money and Your Brain,” *Wall Street Journal* columnist Jason Zweig examines a heretofore little-known aspect of behavioral finance: neuroeconomics, or how our brains respond in real-life financial situations. I recently sat down with Jason to discuss investor behavior, the 2008 market crash, and his tips for becoming a better investor.

**Christine Benz** People may be familiar with behavioral finance. How is neuroeconomics different?

**Jason Zweig** What neuroeconomics does is take the high-technology tools of contemporary neuroscience, which center on the ability to observe activation in the brain at the regional level. So you’re able to see which areas of the brain are activated under particular circumstances, and then you correlate that activity to behavior and also to the stimulus that triggered the activity in the first place.

So, for example, if our objective is to learn something about the brain processes that determine risk-seeking behavior, we might present somebody with the option to make a small amount of money or lose a large amount of money, and see what’s happening at the level of neurons in that person’s brain. The best-established finding is the evidence that Kahneman and Tversky presented roughly 30 years ago, that people feel the intensity of a loss about twice as strongly as they feel the pleasure of an equivalent gain. So losing \$100 hurts 2 to 2 ½ times more than winning \$100 feels good. The neuroeconomic experiments tend to confirm that because they show that losing money activates parts of the brain that are associated with physical pain or disgust, like smelling vomit or stepping in dog doo. So that’s the first level that confirms it.

**You went through some of this testing to examine your own brain’s response to financial**

**performance—in relation to some of these stimuli. What were some of the interesting things you found out about yourself?**

The first thing I learned wasn’t particularly surprising to me, and certainly was no surprise to my wife, which is that I perform no better than anybody else, and in some cases worse, on the kinds of tasks that you might be presented with in one of these experiments. I think the only unusual thing about me is that I’ve been shown in at least one experiment to have an unusual degree of patience. I’m willing to wait considerably longer than the typical person to get a reward.

**And that’s an advantage in investing.**

It is, but what’s interesting about that is that that’s not exactly what my brain scan showed. It’s what a behavioral test showed. So it appears that through many years of training and discipline, and studying Benjamin Graham’s work, and simply observing the markets and learning about financial history, I seem to have trained myself to become more patient than my genetic and biological makeup would suggest I naturally am.

The biggest and most surprising lesson to me came in an experiment that I did at Emory University. It was an example of what Gregory Berns, the neuroscientist who did the experiment, calls “learning without awareness.” It turns out there are very powerful functions in the brain that enable us to recognize

patterns without ever becoming aware we've been exposed to them. This pattern-seeking behavior in the human mind is just an incredibly powerful function. Most of us don't realize how automatic it is, and at what an involuntary level it occurs. So a lot of the trading behavior and what we might call "Cramer-like" behavior, where people see something happen two or three times in a row and just assume it's going to happen again, that sort of thing goes on in your brain whether you want it to or not. And it can drive your behavior even when you're trying to resist it unless you have formal decision structures in place to prevent yourself from acting on it.

“This pattern-seeking behavior in the human mind is just an incredibly powerful function. Most of us don't realize how automatic it is, and at what an involuntary level it occurs.”

In these particular experiments I was being asked to engage in a probability guessing experiment that required a lot of conscious thought, much like playing a game of checkers or backgammon. Simultaneously, I was being presented with a much more basic stimulus, which was that I was getting little sips of sugar water. And there was a pattern to the sips of sugar water that my conscious brain paid no attention to because I was trying to solve the more complicated problem. But the unconscious part of my brain soon detected what was happening with the sugar water. And the next thing I knew, I was pressing madly with my right index finger to indicate that I had solved the problem, even though I had no idea how I had done it. And it was simply that the pattern of sugar water had started to repeat and that part of my brain recognized this repetition, while the conscious part of my brain was still searching for a solution. That sort of thing goes on all the time in the financial markets. And individual investors do it, and financial advisors too do it, without realizing it. And that's why we need formal decision rules.

There's been a real cult in the past few years of intuition and gut feeling and hunches. It kind of started with Malcolm Gladwell's book *Blink*, and now there's a whole cottage industry devoted to helping people

tap their inner dartboard. At least when it comes to financial decision-making, it's hard to imagine a worse way to go about things. It's not that you should never listen to your gut or that your intuition is always unreliable. It's that intuitions are a good guide only under very specific instances, and it's primarily dependent on the nature of feedback. Think of a professional tennis player, for example. Every decision is consequential. If you make a mistake, you fall behind in the game because your competition is intensely competitive, millions of dollars may hang on the result, and the feedback is instantaneous. If there's a hitch in your swing, the ball goes the wrong way and you know it went the wrong way.

Now think about feedback in the financial markets. You buy ChristineCorp and you pay \$10 a share. So by the end of the day it's at \$10.05, and you pat yourself on the back and say, "I'm a good stock-picker." And the next day it goes down to \$9.50, and suddenly you think you're a bad stock-picker. So you sell it and the next thing you know it goes up to \$12. And then what do you decide? Well, you can assume you're a good stock-picker, because it went up 20% above your original purchase price, or you can conclude you don't know what you're doing because you sold at exactly the wrong time. The quality of the feedback varies constantly. At any given moment, you can look right or wrong because the quality of the feedback depends on the length of the measurement period. So there's lousy feedback in the financial markets. It's noisy, it's delayed, it's ambiguous, and also you can cherry-pick it to lie to yourself, or to present yourself in a better light to other people.

Because of that, it's especially important to have really good decision structures. So the first thing is to have a checklist, and to study your past decisions, and to study the decisions of the world's best investors, and learn from your mistakes and theirs and come up with a set of criteria that every investment has to meet in order to be eligible for inclusion in your portfolio. I suggest a few in my book, but for individual investors, probably the most important rule would be never buy an investment purely because it has been going up in price, and never sell it purely because it has been going down.

I would put the expense ratio first for mutual funds. I would say, I will never consider a fund with expenses over X. And then I would probably factor in portfolio turnover, I would factor in tax efficiency, I would put in a measure of risk, and I would put performance dead last. In fact, I would also have a decision rule that I can't actually look at the performance of the fund at all until I've determined a short list of funds that passed all the other screens. And only then would I look at performance. Because if you look at performance first, it then becomes an unconscious bias, and it will skew your analysis of everything else you look at. So you have to put performance dead last because otherwise it would be first no matter where you happened to think you're ranking it.

There was a beautiful study that was published in the *The Journal of Finance* a couple of years ago

“Performance-chasing is not purely the province of retail investors. It's not the so-called dumb money on Main Street that buys high and sells low. Everyone does it.”

about the selection of institutional money managers. It basically found that the professionals who pick money managers, in this case it was pension funds, tend to buy high and fire low. They invest in whichever managers have the best trailing three-year performance and then sell whichever have the worst trailing three-year performance. The study showed that if they had flipped their decisions—if they had bought the ones with the worst three-year performance and sold the ones with the best—they actually would have gotten better returns. And of course if they had done nothing—if they had just put the portfolio on ice—they also would have done better. Performance-chasing, despite all the propaganda you hear in the financial industry, is not purely the province of retail investors. It's not the so-called "dumb money" on Main Street that buys high and sells low. Everyone does it.

### How has the recent bear market corroborated some of the findings in your book? Or not?

Let's think back to October or November of last year or March of this year, when the Dow seemed to be headed toward 6000 and people were just terrified. There's no doubt that millions of investors, retail and professional alike, were acting out of sheer uncontrolled fear. And the level of stress that investors felt was unbelievable. And when people are afraid, and when you're feeling stress, not stress in the pop psychology sense but stress in the physiological sense, when your blood pressure goes up, you're sweating, your heart is racing, your hands are shaking, you can't sleep, and you're on the verge of depression, and you're snapping at your family and kicking your dog, people make bad decisions. And they make impulsive decisions, they make big decisions when they should be making small ones. Instead of making incremental adjustments to portfolios, instead of rebalancing at the margin, people bailed out of asset classes entirely or just moved completely into cash. The other thing that neuroeconomics suggests goes on in people's minds in a time of market panic is the automatic perception of illusory patterns—detecting “trends” in random data that simply aren't there. Things that seem to be predictable loom much more important in people's minds. People develop a belief that the future is more knowable. That's stronger in a time of extreme uncertainty.

### So how could investors take steps to ensure they'll act more rationally?

One thing that's really important is a concept I've taken to calling the “financial fire drill.” Maybe we don't need it as much as we did back in 2006 or 2007, but then again, maybe the speed of the market recovery suggests it's a good idea. Essentially, you deliberately create an environment that makes rational decision-making difficult. So, for example, if it's the summer, you would turn off the air conditioning; if it's the winter, you would turn off the heat. You would close all the windows and doors so you cut down on the oxygen level in the room. You put Jim Cramer in an endless loop on the television, maybe pump in the sound of a crying baby or ambulance sirens, filling the room with noises

associated with stress. And then you would have maybe a red light flashing. All of these things are scientifically proven to elevate stress, and of course we all know just from common sense that it's tough to make a decision under conditions like that. And then you would consider a series of portfolio decisions. "GE stock has gone from \$60 to \$5. What do we do?" or "We said we wanted to have 75% in U.S. equities, and the market is down 60% since we made that decision. What do we do?" You have to come up with a way of calmly arriving at a decision that makes sense. And I think one of the ways you need to do that is that you need to imagine the future. And you need to frame the decision as "Let's make sure we do something today that we won't regret six months, a year, five years from now."

I would close this observation with a reminder to everybody, which is now part of American folklore. Think of Sully, the famous captain of the US Airways flight bringing his plane down into the Hudson River and having every single passenger survive. What enabled him to do that? Not his superior knowledge, not knowing more about his airplane, or the Hudson River, than anybody else. What enabled him to do it is practice. And if you've never really practiced what it's like to make a decision in a global financial panic, you can make panicky decisions and you'll crash your plane and you'll kill everybody. But if you've practiced how to stay calm and make a good decision, you stand a better chance of being able to do it. Repetition is the key to calmness.

sification means that if you combine uncorrelated assets you end up with a portfolio that won't go down in value. And that's not what diversification means. First of all, you're not diversified unless you own something that hurts to own. And the second thing is, we have hundreds of years of data on financial markets of various kinds around the world. So far as I know, there's never been a financial crisis in which correlations didn't go up.

When people say diversification failed, they're defining failure in a very strange way. They seem to be saying if, when most assets went down, something didn't go up, then diversification didn't work. And that's not what it ever meant. All it ever meant is that if you have assets that are statistically not highly correlated, putting them together will give you a better trade-off of risk and return. If you look at what happened in the financial crisis, that's what you got. People who owned some stocks and some bonds did better than people who owned all stocks. The fact that the U.S. market went down 37% and foreign stocks and emerging-markets stocks went down also doesn't mean that diversification didn't work, because they didn't all go down exactly 37%. Diversification did work for exactly that reason—you got different rates of return. Diversification isn't a form of insurance; it's just a form of risk control.

All of this reminds me of what you hear from ignorant sports fans. Someone might say, "Carmelo Anthony, he stinks. He's not as good as LeBron James. LeBron is so much better." But that doesn't mean that if you tried going one on one with Carmelo Anthony, you'd outscore him. The problem with this whole "asset allocation is dead" argument is—let's just assume for the sake of argument that asset allocation is dead—what's alive? Where is the long-term evidence with thousands upon thousands of data points over many years and multiple markets, with real money invested—not backtested—where is the evidence that something else has worked? Asset allocation hasn't worked in certain years, but nothing else has either. That's the problem I have with this debate, which is it's easy to say what hasn't worked well lately, but it doesn't mean that all the things that never worked have started to work. ■■■

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**I'm hearing from a lot of investors who say, "Strategic asset allocation is dead, tactical is the way to go." What do you say to that way of thinking?**

This is the \$64 trillion question. In some ways, it's the only question that matters. My view is that diversification is not dead, but people really misunderstood what it means. People thought diver-

# Making a Portfolio Retirement-Ready

Portfolio Makeover | Christine Benz

“I would really be delighted if you considered me in light of the fact that I represent so many single women with no pension but a few assets and no debt who are just closing in on retirement.”

So ended an e-mail I received from Emily Booth (not her real name), who wrote me requesting a portfolio makeover earlier this summer. At 64, she is looking back in satisfaction on her successful career in real estate. But she’s also thinking about the next phase in her life—retirement—and whether her portfolio will afford her the financial stability she’s seeking. With the real estate market in the doldrums over the past few years, Emily’s income has slowed to a trickle, and she’s considering retiring within the next few months.

Before she does, however, she knows that she needs to reposition her investment portfolio. With more than 60% of her assets in cash, she’s rightfully concerned about her portfolio’s limited upside potential. At the same time, she’s worried about moving a lot of money into the market given that stocks have been on a tear for the past six months. Incurring big portfolio losses early in one’s retirement years can be catastrophic, so Emily is seeking guidance not just on what to buy but when and how to buy it.

## The Before Portfolio

Emily’s portfolio, at roughly \$750,000, is a tribute to her careful financial management. She obviously has too much cash, but I like nearly all of her stock and bond holdings. **Dodge & Cox Income** DODIX and **T. Rowe Price New Income** PRCIX, both solid core funds, are the lynchpins of her bond portfolio. She also has several fine funds that combine stock and bond holdings, including **Dodge & Cox Balanced** DODBX, **Vanguard LifeStrategy Growth** VASGX, and **Oakmark Equity & Income** OAKBX. Her pure equity holdings include some of Morningstar’s favorite active funds—**Fairholme** FAIRX, **Third Avenue**

**Value** TAVFX, and **Mairs & Power Growth** MPGFX—as well as a smattering of index funds.

In addition to the careful homework she’s done on investment selection, Emily has also gotten the big picture right. She owns her own home outright and her expenses are manageable, both of which are huge pluses given her proximity to retirement. Emily estimates that she’ll need \$25,000 to \$30,000 a year—in addition to Social Security—to maintain her standard of living in retirement. That’s an income level that her current portfolio should be able to support. She also has purchased a long-term care policy with generous benefits from a highly rated insurance company. The policy premiums are not cheap, at \$2,400 a year, but having this type of insurance affords Emily valuable peace of mind.

## The After Portfolio

As much as Emily has done right, however, there are still a few areas where she can improve. Given her proximity to retirement and the threat that rising costs can pose to a retiree’s purchasing power, Emily’s portfolio lacks inflation protection, so I would recommend allocating at least 20% of her fixed-income portfolio to Treasury Inflation-Protected Securities. I also think she could pick up a more robust total return without taking on a lot of additional risk by investing some of her cash war chest in high-quality bonds and even lower-risk stock funds. Finally, some of her stock holdings overlap with one another. She can prune some of her redundant holdings but still maintain diversification that’s more than adequate.

One starting point for someone like Emily is to determine cash needs, over the near and long term, and allocate assets accordingly. For example, Emily should start by determining her cash needs for the next two years—\$50,000 to \$60,000, based on her projections. She can then leave that money, and little more, in her various cash accounts.

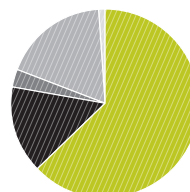
After that, she can think about “laddering” the portfolio based on when she expects to need the assets. For example, for assets she expects to tap in years 3 to 5 of her retirement, she can park them in a short-term bond fund such as **T. Rowe Price**

## Emily's Portfolio: Before

Fund Name	Star Rating	Category/ Industry	Holding Value (\$)	Expense Ratio (%)
<b>T. Rowe Price New Income</b> PRCIX	★★★★	CI	38,560	0.67
<b>Dodge &amp; Cox Income</b> DODIX	★★★★★	CI	33,035	0.43
<b>Fidelity Asset Manager 20%</b> FASIX	★★★★	CA	31,215	0.56
<b>Dodge &amp; Cox Balanced</b> DODBX	★★★	MA	28,414	0.53
<b>Oakmark Equity &amp; Income</b> OAKBX	★★★★★	MA	27,844	0.81
<b>Fidelity Balanced</b> FBALX	★★★★	MA	26,247	0.61
<b>Vanguard LifeStrategy Growth</b> VASGX	★★★★	LB	26,113	N/A
<b>ExxonMobil Corp</b> XOM	★★★★★	Energy	18,406	N/A
<b>Vanguard Intermediate-Term Tax-Exempt</b> VVITX	★★★★	MI	16,945	0.15
<b>Vanguard Total Stock Market Index</b> VTSMX	★★★	LB	10,323	0.16
<b>Vanguard GNMA</b> VFIIX	★★★★★	GI	10,093	0.22
<b>Dodge &amp; Cox International Stock</b> DODFX	★★★★	FV	8,469	0.64
<b>T. Rowe Price Health Sciences</b> PRHSX	★★★★	SH	7,288	0.86
<b>Third Avenue Value</b> TAVFX	★★★	WS	7,275	1.11
Cash	N/A	N/A	463,599	N/A
<b>Total (including 5 holdings not shown)</b>			<b>769,612</b>	

Super Sector Weighting (%)		Top Three Sectors (%)	
Information	16.23	Energy	22.04
Service	40.58	Health	17.28
Manufacturing	43.19	Financial Svs	13.41

### Asset Allocation (%)



- Cash 63.00
- U.S. Stock 15.00
- Foreign Stock 3.00
- Bonds 18.00
- Other 1.00

### Equity Style (%)

Value	Blend	Growth	
25	32	19	Large
6	7	8	Medium
1	1	2	Small

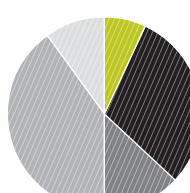
0-10 11-25 26-50 51-100

## Emily's Portfolio: After

Fund Name	Star Rating	Category/ Industry	Holding Value (\$)	Expense Ratio (%)
<b>Oakmark Equity &amp; Income</b> OAKBX	★★★★★	MA	150,000	0.81
<b>Dodge &amp; Cox Income</b> DODIX	★★★★★	CI	100,000	0.43
<b>T. Rowe Price Short-Term Bond</b> PRWBX	★★★★	CS	100,000	0.55
<b>Vanguard Inflation-Protected Securities</b> VIPSX	★★★★	IP	50,000	0.2
<b>ExxonMobil Corp</b> XOM	★★★★★	Energy	18,406	N/A
<b>Vanguard Total Stock Market Index</b> VTSMX	★★★	LB	50,000	0.16
<b>Fairholme</b> FAIRX	★★★★★	LB	50,000	1.01
<b>Mairs &amp; Power Growth</b> MPGFX	★★★★	LB	50,000	0.7
<b>Dodge &amp; Cox International Stock</b> DODFX	★★★★	FV	50,000	0.64
<b>Third Avenue Value</b> TAVFX	★★★★	WS	25,000	1.11
<b>Harbor International Growth</b> HIIGX	★★★	FG	25,000	1.26
<b>Harbor Commodity Real Return</b> HACMX	N/A	SN	25,000	0.94
Cash			76,205	N/A
<b>Total</b>			<b>769,612</b>	

Super Sector Weighting (%)		Top Three Sectors (%)	
Information	10.57	Financial	16.90
Service	44.08	Industrial Matls	16.76
Manufacturing	45.34	Health	16.40

### Asset Allocation (%)



- Cash 7.00
- U.S. Stock 30.00
- Foreign Stock 13.00
- Bonds 40.00
- Other 10.00

### Equity Style (%)

Value	Blend	Growth	
24	28	18	Large
6	11	8	Medium
2	2	1	Small

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

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### Categories

<b>CA</b> Conservative Allocation	<b>LB</b> Large Blend
<b>CI</b> Intermediate-Term Bond	<b>MA</b> Moderate Allocation
<b>FG</b> Foreign Large Growth	<b>MI</b> Intermediate Muni
<b>FV</b> Foreign Large Value	<b>SH</b> Health
<b>GI</b> Intermediate Govmnt	<b>SN</b> Natural Resources
<b>IP</b> Inflation-Protected Bond	<b>WS</b> World Stock

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Making a Portfolio Retirement-Ready  
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**Short-Term Bond** PRWBX or even a conservative intermediate-term bond fund like Dodge & Cox Income. I'm recommending a combination of the two.

Assets for years 6 through 10 can go in an intermediate-term bond fund and, at least in part, conservative wide-moat stock funds. (I've identified some of my favorites on Page 3.) Emily's several stock/bond combination funds would also work well in this sleeve of her portfolio. I'm a big fan of Dodge & Cox Balanced and Oakmark Equity & Income. I'd favor the latter, largely because Emily has plenty of exposure to Dodge & Cox elsewhere in her portfolio. I would also cut her position in **Fidelity Balanced** FBALX.

For the long-term portion of Emily's portfolio (10-year time horizon and longer), many of her current holdings provide a solid foundation. I also like that Emily's portfolio mixes index and active funds. However, holding both **Vanguard 500 Index** VFINX and **Vanguard Total Stock Market Index** VTSMX creates redundancies. I'd recommend cutting the 500 fund and enlarging the position in Total Stock Market Index, which has somewhat broader reach. I'd also like to see Emily add to her portfolio's foreign-stock exposure, as she's currently quite light in this area. **Dodge & Cox International Stock** DODFX is a great building block, but she might also consider a complementary growth-oriented fund such as **Harbor International Growth** HIIGX. **IM**

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