A Lifetime of Asset Allocation Portfolios

The first generation of asset allocation funds utilized the same investment mix regardless of investor age or circumstances. Today, asset allocation funds are more targeted in their approach. There are almost as many asset allocation strategies as there are mutual funds. Typical asset allocation calls for 60% in stock funds and 40% in bond funds. From here, percentages are altered by many factors, including:

- age,
- time horizon,
- purpose of investing,
- work status,
- need for investment income,
- lump-sum investment or long-term periodic investing
- and the degree to which the investing goals have been reached

We believe these various considerations will dictate a portfolio makeup ranging from a most aggressive stock / bond ratio of 80/20 to a conservative stock / bond ratio of 20/80. While many investors and advisors alike construct senior portfolios comprised strictly of fixed income investments, we believe that even the most conservative income-oriented elderly investor needs purchasing power protection, which traditionally comes from owning equities (stocks) not debt (bonds).

In November 1998, long before they became fashionable, we created four distinct investment portfolios to specifically track the investor lifecycle. It's true, ask our long time subscribers. Here is how they have performed:

Through October of 2007, they performed in accordance with the level of risk associated with each life cycle.

LIFECYCLE PORTFOLIO	BENCHMARK	Cumulative Growth Nov-98 to Oct-07
Accumulator Portfolio . . .		110.27%
vs	*vs S&P 500 Total Return Index*	53.47%
Transition Portfolio . . .		72.86%
vs	*vs Blend-60% S&P 500/ 40% Barclays Bond Aggregate*	60.42%
Retirement Portfolio . . .		77.14%
vs	*vs Blend-30% S&P 500/ 70% Barclays Bond Aggregate*	62.39%
Senior Retirement Portfolio . . .		63.00%
vs	*vs 1-Yr CD High-Yield*	46.68%

** Barclays Capital – formerly Lehman Brothers*

Then the market crashed, cratering these numbers, but once again proving the value of allocation during an investor's lifetime.

LIFECYCLE PORTFOLIO		BENCHMARK	Cumulative Growth Nov-98 to Dec-10
Accumulator Portfolio . . .			89.14%
	vs	*vs S&P 500 Total Return Index*	25.48%
Transition Portfolio . . .			72.85%
	vs	*vs Blend-60% S&P 500/ 40% Barclays Bond Aggregate*	57.24%
Retirement Portfolio . . .			92.45%
	vs	*vs Blend-30% S&P 500/ 70% Barclays Bond Aggregate*	79.63%
Senior Retirement Portfolio . . .			88.65%
	vs	*vs 1-Yr CD High-Yield*	59.19%

Look at how much value was lost from each of the lifecycle portfolios. With plenty of time to recover, the Accumulator Portfolio suffered the largest loss, but the 19% loss of the well-allocated portfolio paled in comparison to the benchmark S&P 500 TTR loss of 52%. As the investor aged, the loss was mitigated or eliminated altogether.

LIFECYCLE PORTFOLIO	Cumulative Growth Nov-98 to Oct-07	Cumulative Growth Nov-98 to Dec-10	Pct of Portfolio Lost	BenchMark Loss Pct
Accumulator Portfolio	110.27%	89.14%	-19%	-52%
Transition Portfolio	72.86%	72.85%	-1%	-5%
Retirement Portfolio	77.14%	92.45%	+20%	+27%
Senior Retirement Portfolio	63.00%	88.65%	+41%	+26%

Following is a look at each portfolio.

Phase I — The Accumulator Portfolio

The most aggressive asset allocation portfolio, calling for an 80/20 split, is the standard bearer for all investors with a long-term horizon — *the accumulators*. It is the proper mix for the youngest of investors to those investors still in their 40s. It gives them maximum exposure to the stocks that should have the greatest impact on the growth of their investment portfolios, while they are still young enough to recover from any large scale downturns in the stock market. This recovery would consist of both the re-growth of the stock market and the additional portfolio contributions the investors could make from their wages.

The 80/20 portfolio needs to be further subdivided. How should the 80% in stocks be invested? Which mutual fund categories should be considered and which one eliminated? And how about the percentages or weighting for each chosen category?

Here is the breakdown of the A*ccumulator Investment Portfolio*:

Large Cap Core	20%	Sector – Energy	4%
Large Cap Growth	10%	Sector – HealthCare	7%
Large Cap Value	10%	Sector – Financial Services	4%
Mid Cap	7%	Bonds – U.S. Government	0%
Small Cap	8%	Bonds – Convertible	10%
International Equity	15%	Bonds – Corporate Hi-Yield	0%
Emerging Markets	5%	Bonds – Corporate Inv-Grade	0%
		Bonds – International	0%

Balanced and utility stock funds could also be added to or substituted for the corporate and corporate hi-yield funds, while municipal bonds could serve the high tax-bracket investors.

Since we first created this model (Nov-98), the Accumulator Portfolio has produced a cumulative return of 89.14% through December 2010, while the S&P 500 Total Return generated 25.48%

Phase II — The Transition Portfolio

During the accumulation phase of investing, the focus should rightfully be on maximizing return, but investors who are not too far from retirement can be devastated by a market correction. This correction may generate portfolio losses from which the investor may find it difficult to recover:

Crash	Lost		Back to Even	
Sep-29 to Jun-32	21 months	-83.46%	Nov-44	149 months
Dec-72 to Sep-74	21 months	-42.71%	Jun-76	21 months
Aug-00 to Sep-02	25 months	-44.73%	Oct-06	49 months
Oct-07 to Feb-09	14 months	-50.95%	Jul-11	45 months only 85% whole

these are S&P 500 Total Return figures

- Year-end Client Review Example #1:
    - A 60 year-old investor with a $1,000,000 portfolio had a goal of earning 10% per year to fulfill his retirement needs of age 65. In December 1999, the market had been going gangbusters. Given the environment in 1999, he considered his 10% annual goal a conservative one. Using the rule of 72, he projected that his S&P 500-like portfolio would be worth $1,610,510 when he retired at the end of 2004. He figured the portfolio would generate about $80,000 in annual retirement income, while still keeping pace with inflation. Unfortunately, the market crash that was around the corner burned over half of his portfolio value, leaving him with an account balance of $624,000 at year-end 2002. Stunned and wanting to preserve what was left, he runs to the safe confines of a bank certificate of deposit. From December of 2002 until he retired in December 2004, the CD grows to be worth $654,000 and generates only $33,000 in annual retirement income, with no inflation protection.

    - If he had left the portfolio intact, its December 2004 value would only have been $890,000, generating $45,000 in annual retirement income.

- Year-End Client Review Example #2
    - A 55 year-old investor with a $1,000,000 portfolio had a goal of earning 10% per year to fulfill his retirement needs of age 65. It was December 1972 and the market had been going gangbusters. Using the rule of 72, he projected that his S&P 500-like portfolio would be worth $2,600,000 when he retired at the end of 1982. He figured the portfolio would generate about $130,000 in annual retirement income, and still provide enough growth to cover inflation. Unfortunately, the market crash that was imminent his portfolio value to a 1974 year-end value of $626,000. He then ran to the safe confines of a bank certificate of deposit. From December of 1974 until he retired in December 1982, the CD grows to be worth $1,300,000 and generates only $65,000 in annual retirement income.

- If he had left the portfolio intact, its December 1982 value would have been $1,901,000, generating $95,000 in annual retirement income.

- Year-End Client Review Example #3
  - A 60 year-old investor with a $1,000,000 portfolio had a goal of earning 10% per year to fulfill his retirement needs of age 65. In December 2005, the market had rebounded beautifully from the crash of 2000. Given the environment, he considered his 10% annual goal a realistic one. Using the rule of 72, he projected that his S&P 500-like portfolio would be worth $1,610,510 when he retired at the end of 2010. He figured the portfolio would generate about $80,000 in annual retirement income, while still keeping pace with inflation. Unfortunately, the market crash that was around the corner and burned half of his portfolio value, leaving him with an account balance of $629,000 at the end of March 2008. Stunned and wanting to preserve what was left, . . . here we go again? How will this one turn out? Probably like the last ones.

So, as investors get closer to retirement, their allocations should begin to change to reflect a new investment focus — minimizing risk. A sound strategy for pre-retirees is to slowly convert the portfolio of funds beginning shortly after age 50 or ten years prior to retirement.

This *transition investor* should alter the portfolio makeup from an 80/20 split to a more conservative 60/45 split. In addition, the more aggressive fund categories should either be replaced with more conservative fund categories or the weighting of the categories should be biased toward the more conservative. Here is the *Transition Investment Portfolio*:

Large Cap Core	20%	Sector – Energy	0%
Large Cap Growth	10%	Sector – HealthCare	0%
Large Cap Value	15%	Sector – Financial Services	0%
Mid Cap	0%	Bonds – U.S. Government	10%
Small Cap	5%	Bonds – Corporate Hi-Yield	5%
International Equity	15%	Bonds – Corporate Inv-Grade	15%
Emerging Markets	0%	Bonds – International	5%

This transition to a pre-retirement portfolio may be done gradually or all at once. It also may be done fifteen years from retirement or as little as five years from retirement. The decision of when to move to a transition portfolio will depend largely upon how on-track the investor is to fulfilling the retirement investment goal. If the investor is on track or ahead of schedule, there is no need to continue taking the risk of the accumulator portfolio. On the other hand, if the investment contributions or performance have been lacking, the transition may have to wait or be done more gradually. Of course, tax consequences should be considered for the speed with which the transition takes place. In either case, this transition portfolio ends up reflecting both a decrease in overall exposure to stocks and a flight to more conservative stock funds.

Since we first created this model (Nov-98), the Transition Portfolio has produced a cumulative return of 72.85% through December 2010, while the benchmark blend 60% S&P 500 / 40% Barclay's Aggregate Bond generated 57.24%

Phase III — Retirement Portfolio

A common retirement strategy used by many retirees is to purchase large blocks of long-term US government bonds. This strategy seems safe, but it can be devastated by inflation. For instance, had an investor about to retire in 1972 bought $250,000 worth of twenty year government bonds, he/she would have produced a guaranteed income of $18,750 per year. Unfortunately, while those bonds continued to produce the same guaranteed $18,750 in 1992, the inflation-adjusted purchasing power of the $18,750 fell to $5,625. To make matters worse, the guaranteed principal returned at the maturity of the bonds had an inflation-adjusted 1972 value of $75,040.

So while retired investors need to become more conservative, investment growth is still important. Retirees can expect to live 20 years or more, so they should still seek investments for the long term. If the cost of goods and services rises by an inflation rate of 3% annually, twenty years into retirement, those same goods and services will be 80% more expensive. Without the portfolio growth provided by stocks, investors living off of a conservative 6% yield would need to pursue a much riskier 11% rate of return to produce the same living standard. Here is the R*etirement Investment Portfolio*:

- Large Cap Core 10%
- Large Cap Growth 0%
- Large Cap Value 15%
- Mid Cap 0%
- Small Cap 0%
- International Equity 10%
- Emerging Markets 0%
- Sector – Energy 0%
- Sector – HealthCare 0%
- Sector – Financial Services 0%
- Bonds – U.S. Government 20%
- Bonds – Convertible 10%
- Bonds – Corporate Hi-Yield 0%
- Bonds – Corporate Inv-Grade 20%
- Bonds – International 15%

Since we first created this model (Nov-98), the Retirement Portfolio has produced a cumulative return of 92.45% through December 2010, while the benchmark blend of 30% S&P 500 / 70% Barclay's Aggregate Bond generated 79.63%

Phase IV — Senior Retirement Portfolio

In the later years of retirement, around age 75, the portfolio should make its final adjustment by further reducing the risk to the portfolio. This *later-years retirement* portfolio historically needs no more than a 20% exposure to equities. That way, purchasing power against inflation may be maintained. Again, the speed of the portfolio changes and the timing of the moves should be dictated by the degree of comfort the current retirement portfolio provides. If the portfolio is barely meeting its income goals, it would not be prudent to further reduce its income-generating possibilities. If the portfolio is indeed meeting its income obligation to the retirees, then the conversion to the later-years retirement portfolio should take place without haste.

Here is the *later-years or Senior Retirement Investment Portfolio*:

Large Cap Core	0%	Sector – Energy	0%
Large Cap Growth	5%	Sector – HealthCare	0%
Large Cap Value	10%	Sector – Financial Services	0%
Mid Cap	0%	Bonds – U.S. Government	50%
Small Cap	0%	Bonds – Convertible	0%
International Equity	5%	Bonds – Corporate Hi-Yield	0%
Emerging Markets	0%	Bonds – Corporate Inv-Grade	20%
		Bonds – International	10%

Since we first created this model (Nov-98), the Senior Retirement Portfolio has produced a cumulative return of 88.65% through December 2010, while the benchmark One-Year High Certificate of Deposit generated 59.19%

During the last decade, we have had two devastating market crashes (Aug 2000-Sep 2002) and 2008 (Oct 2007-Feb 2009), yet these portfolios stood strong. Here are the cumulative return comparisons of our four lifetime portfolios and the returns of the S&P 500 Composite Total Return Index and the Barclays Aggregate Bond Index.

Remember, the market giveth and the market taketh away. This is most important when looking at the end game of a lifetime of investing. We hope these allocation models prove helpful in your efforts to satisfy the long-term investment goals of all your valued clients.