Kiplinger's PERSONAL FINANCE

Build Your Perfect Retirement Portfolio

Use these guidelines to diversify your investments, reduce your risk and meet your savings goals.
By Katy Marquardt
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When you hear the word *hobby*, you probably think of typical pastimes, such as photography, gardening and tennis. Not Jeff Blades. The St. Louis resident would rather spend his free time training for the ultimate challenge: Iron Distance triathlons. These races include a 2.4-mile swim, a 112-mile bicycle race and a 26.2-mile marathon -- back to back to back. Blades, who has completed 70 triathlons (and is signed up for several more this year), says pacing is the secret. "Simply put, short-term thinkers do not survive the grueling 140.6 miles," he says.

Blades, who works in software sales, applies the same discipline to managing his mutual fund portfolio. You might even call investing his other hobby. Each year, he maxes out his 401(k) contribution as early as possible (the limit is $15,500 this year). "I want that money working on a tax-deferred basis right away," Blades says. He also invests in a mutual fund gift trust, which will serve as a college fund for his son, Nathan, 11, and daughter, Kelsey, 9.

Blades is a zealot when it comes to diversification, and he maintains a careful balance among funds that target various investing styles, market sectors and companies of different sizes. His investments are a mix of index funds and actively managed mutual funds, with a chunk of real-estate holdings and a slice of individual stocks.

At 46, Blades isn't thinking of retiring anytime soon. "I try not to equate retirement with a specific dollar threshold, so I don't have a predetermined age or asset level," he says. "My goal is to double my assets every five years." He's already met that goal several times over the years, and his portfolio continues to grow at a steady clip.

In Blades's investing strategy, the funds he picks and the way he mixes them are of equal importance. Before you begin experimenting with funds in your own investment recipe, you'll need to think about your investment goals, time horizon and tolerance for risk. "You don't just decide to run a marathon," says Keith Newcomb, a Nashville financial planner. "You must prepare and assess the landscape. The single most important thing to do is lay the foundation before you start picking your investments."

This article will give you the tools to construct your own portfolio, as well as suggest well-diversified model portfolios you can adopt as your own. Each of our models contains one portfolio of actively managed funds and one made up of lower-cost index funds.

Why diversify?

History proves that different types of stocks take turns leading the market. Some go out of favor -- or go gangbusters -- for years at a time. The past five years, for example, have been unkind to funds that invest in stocks of big, growing companies. Meanwhile, funds that specialize in small and midsize companies that are underpriced have enjoyed supercharged returns. Many analysts and money managers now believe that the tide is turning to favor large-company growth stocks once again.

Such shifts in style are largely unpredictable, so you won't have steady growth if you invest in only one type of stock. "The more diversified, the smoother and safer the portfolio will be on the way from point A to point B," says Newcomb. "While some funds may fluctuate wildly, the basket is going to fluctuate less overall."

Given that over long periods of time small-company stocks provide greater returns than large-company stocks, you'll want at least one fund that invests in the little guys. But because stocks of small companies are riskier, you should also devote space in your portfolio to larger companies, which are less volatile. Invest in funds that seek growth stocks as well as those that specialize in value stocks. Growth companies are typically those with rapidly accelerating sales and profits, while value stocks aren't growing as quickly and are considered cheap relative to their peers.

Also make room for a fund that invests in foreign stocks. Because the returns of foreign stocks typically don't move in lock step with U.S. stocks, injecting your portfolio with an overseas fund can add more diversification.

For example, let's say your portfolio only held T. Rowe Price Growth Stock, a fund that invests in large companies with above-average growth. The fund is a star in its category: It has beaten 89% of its rivals over the past five years. But because the fund's style has been out of favor, it only returned an annualized 7% during that time. If you had paired Growth Stock with a small-company fund -- LKCM Small Cap Equity, for example -- your portfolio's annualized five-year return would have been 11%.

As a rough guide, aim to put about half of your money in funds that invest in the stocks of large companies, split between growth and value. Put 25% of your money in a foreign fund, and divide the final 25% among small-company funds that invest in growth stocks and value stocks (or put it in one blended fund that covers both styles).

Blades's devotion to diversification helped him survive the dot-com crash earlier this decade relatively unscathed. At the height of the bubble, his portfolio had a modest 10% in tech stocks. "Tech was way overvalued," he says. "It was scaring me even when I was making money." One remnant of tech mania, however, remains on Blades's roster: Jacob Internet fund, which is down an annualized 20% since the bubble burst in March 2000. "It's my single emotional buy and a reminder that emotion and money make very poor bedfellows," he says.

Beware of sector swings

Blades is right to be cautious of sector-specific funds, which are narrowly focused and therefore prone to extreme swings in performance. Gold funds are another classic example. Take U.S. Global Investors

Gold Shares, which beat 99% of all funds in 2006 with an eye-popping 50% return. The fund also performed extraordinarily in 2002 and 2003, with returns of 81% and 67%, respectively. But then consider 2004: The fund fell 6% that year, placing it in the bottom 1% of funds of any kind. In 2000, it plunged 30%, and in 1997, the fund lost more than half of its value.

If you decide to take a chance on a sector-specific fund, make it a small slice of your portfolio, and be sure you can handle roller-coaster volatility. "Playing sectors is difficult. People are always saying they want energy, India and China, but they often end up chasing past performance," says Kyra Morris, a financial planner in Charleston, S.C. That means investors buy funds *after* the funds have had a blockbuster year. But because funds run hot and cold, investors often end up buying at the wrong time -- and losing money.

Stocks versus bonds

The amount you devote to stock funds and bond funds is a major decision when building a portfolio. Over the long haul, it's clear that stocks provide the best returns. Since 1926, stocks have returned an annualized 10%, according to Ibbotson Associates, a Chicago investment-research firm. Over that time, bonds returned an annualized 5%, and cash, just 4%. With inflation averaging 3% since 1926, your real, after-inflation return is reduced to 7% for stocks, 2% for bonds and 1% for cash.

In the long term -- *long* being the key word -- stocks aren't as risky as you might think. Over rolling ten-year periods (for example, 1960 through 1969, 1961 through 1970, and so on), including periods that span the Great Depression, stocks have never lost more than an annualized 1%. And over 20-year periods, stocks have never lost money.

But stocks behave erratically in the short term. In their worst year since 1926, stocks fell 43% in 1931. In their best year since the Depression, they gained 54% in 1933. You can reduce the risk of investing in stocks either by increasing the time you hang on to your stocks or by adding bonds to the mix.

With bonds, you trade potential show-stopping returns for even-keel performance. For example, say you owned only Hodges fund, a growth-oriented fund that invests in stocks of all sizes. Over the past five years, the fund produced an annualized 20% return -- but it was 40% more volatile than the benchmark Standard & Poor's 500-stock index. Talk about thrills and spills. If you had added Harbor Bond fund to your portfolio, your annualized five-year return would have been a very respectable 13%, but you would have cut your portfolio's volatility in half.

As you decide how much to put in stocks, consider your feelings about losing money. If you break out in a sweat with each market dip, you may need to trim your stock holdings. If you want to harvest the biggest gains the market has to offer, you'll need fortitude to sustain a temporary market loss of 30% or more without bailing out at the bottom.

Your personal goals

Another major factor in portfolio construction is how soon you'll need the money. If you're in your thirties, forties or early fifties and you're investing for retirement at age 65, you can justify investing virtually all your money in stocks. Ditto if you're investing for your toddler's college education.

Blades, who is in his forties, prefers a pure-stock portfolio and plans to keep it that way until he's within five years of retirement -- and maybe even longer.

As you get closer to needing your money, the volatility of stocks demands that you invest more cautiously, which means increasing the percentage of bonds or cash. "Bonds serve as a sort of psychological safeguard," says P.J. DiNuzzo, a financial adviser in Beaver, Pa. "The number-one reason you want them in your portfolio is to lower risk and volatility." But don't abandon stocks altogether, even if you're several years into retirement. DiNuzzo recommends keeping at least one-third of your investments in stock funds well into your seventies. "You don't want to pull all of your potential growth off the table," he says.