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Build Your Perfect Portfolio

With the proper mix, your combined investments will be less risky and tailored to meet your goals.

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February 18, 2008

EDITOR'S NOTE: This article is from Kiplinger's Mutual Funds 2008 *special issue. Order your copy today.*

The most important decision you'll make as an investor isn't which fund to buy. More vital to your long-term financial success is how you split money among different types of stocks and bonds. This asset selection will have the most effect on the two things you want to control most in your portfolio: the total return and the level of volatility. A smart, well-diversified portfolio gets you both a good return and low volatility. It's the financial equivalent of having your cake and eating it, too.

It's true that, for example, some small-company stock mutual funds are better than others. But when small-company stocks rally, all small-company funds tend to be swept along for the ride. And when it comes to volatility, studies have shown that simply spreading your money over different types of assets—not market timing or picking individual stocks -- accounts for 90% of reduced risk in a portfolio.

Think of how you will spread your money among different types of stock funds "as assembling a baseball team with players of different talents," says Michael Branham, a financial planner in Edina, Minn. "Just as you need a center fielder and a shortstop, you need different types of stock funds, which shine at different times."

Once you're set on a plan for a diversified portfolio, then you can worry about selecting the best funds in each category. We've taken that worry away from you by suggesting portfolios using our favorite mutual funds -- those in our Kiplinger 25 list.

This article will explain a little about different types of investments, and then give you three model portfolios you can adopt for your own. Each is intended for a different time horizon and tolerance for risk.

Stocks versus bonds

History does provide us with some guidance: 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%.

In the long term -- long term being key -- stocks aren't as risky as you might think. Over rolling ten-year periods, including the Great Depression, stocks have never lost more than an annualized 1%. And over

rolling 20-year periods, stocks have never lost money.

The flip side of that equation is that stocks behave erratically in the short term. In their worst year since 1926, stocks fell 43% (1931); in their best year (1933), they gained 54%.

As you decide on your stock breakdown, take into account your feelings about losing money. If you break out in a sweat with each market dip, you may need to trim your stock holdings and add bonds or even cash. Successful investors need the fortitude to sustain a temporary market loss of 30% or more without bailing out at the bottom.

Your personal goals

Just as important as your personal tolerance for risk and volatility is your time horizon. If you're in your thirties, forties or early fifties and you're investing for retirement at age 66 or 67, you can justify investing virtually all of your money in a diversified portfolio of stocks. Ditto if you're investing for your toddler's college education.

But 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 you shouldn't abandon stocks, even if you're several years into retirement. DiNuzzo recommends keeping at least a 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.

Why diversify?

Once you've decided how much to invest in stocks and bonds, determine how you'll spread your money among different types of stock funds. 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.

Shifts in style are largely unpredictable, so you won't have steady growth if you invest in only one style. 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.

For example, when the tech bubble started to burst in 2000, big-company stocks dropped 10%. But in that same year, small-company stocks rose 12%. Adding bonds to the mix also cuts back on the highs and lows. In 2000, 2001 and 2002, when big-company stocks lost 10%, 13% and 23%, a broad sampling of bonds gained an impressive 12%, 8% and 10%.

Invest in funds that seek growth stocks as well as those that specialize in value stocks. This is a good strategy because, just like big-company and small-company stocks, growth and value stocks tend to rise and fall at different times. Growth companies are typically those with rapidly accelerating sales and profits, while value stocks are considered cheap relative to their peers. Don't forget to make room for a fund that invests in foreign stocks. Because foreign stocks don't typically move in lock step with U.S. stocks, giving your portfolio some foreign flavor adds more diversification.

Foreign stocks are especially important these days because the growth of many overseas economies is dwarfing growth of the U.S. economy. Stock prices tend to reflect such growth. The Morgan Stanley

EAFE (Europe, Australasia and Far East) index has returned an annualized 24% the past five years, versus 12% for the U.S. equivalent, Standard & Poor's 500-stock index.

Model portfolios

Long-term: 10+ years away

Let compounding work its magic for you as you save for long-range goals, such as retirement. We've assembled an all-stock portfolio with a nice blend of growth and value funds, and large-, midsize- and small-company funds. Foreign stocks get 25% of the money, including 5% in an emerging-markets fund. For further diversification, you might want to add a slug of real estate investments. Consider taking 5% from Dodge & Cox International Stock and putting it in **Fidelity International Real Estate** (FIREX), which is up an annualized 19% over the past three years.

20% Selected American Shares (SLASX/Large-cap value) **15% Marsico 21st Century** (MXXIX/Large-cap growth) **15% Bridgeway Aggressive Investors 2** (BRAIX/All-cap growth) **15% Excelsior Value & Restructuring** (UMBIX/Large-cap value) **10% Baron Small Cap** (BSCFX/Small-cap growth) **20% Dodge & Cox International Stock** (DODFX/International) **5% T. Rowe Price Emerging Markets** (PRMSX/International)

Medium-term: 5 to 10 years

You're getting closer to your goal—be it retirement, paying for college or fulfilling some other large call on cash—so we've reduced the risk of this portfolio by allocating 30% to a bond fund, which should help your portfolio achieve smoother performance. Otherwise, we prescribe a diversified stock portfolio with healthy portions of small-, midsize- and large-company stocks.

15% Selected American Shares (SLASX/Large-cap value) **10% T. Rowe Price Equity Income** (PRFDX/Large-cap value) **15% Marsico 21st Century** (MXXIX/Large-cap growth) **10% Baron Small Cap** (BSCFX/Small-cap growth) **15% Dodge & Cox International Stock** (DODFX/International) **30% Loomis Sayles Bond*** (LSBRX/Global corp.) **5% T. Rowe Price Emerging Markets** (PRMSX/International)
* In a taxable account, use **Fidelity Spartan Intermediate Municipal Income** (FLTMX) instead.

Short-term: Fewer than 5 years

You need to think more in terms of preservation of capital and current income at this stage, so we've bumped up the weighting in bond funds to 40%, split among three funds with very different strategies. But too many people invest too conservatively when they retire, running the risk of outliving their savings. So we've maintained a 60% position in stock funds.

15% Selected American Shares (SLASX/Large-cap value) **10% Vanguard Primecap Core** (VPCCX/Large-cap blend) **10% T. Rowe Price Equity Income** (PRFDX/Large-cap value) **10% Baron Small Cap** (BSCFX/Small-cap growth) **15% Dodge & Cox International Stock** (DODFX/International)

20% Loomis Sayles Bond* (LSBRX/Global corp.) **10% Dodge & Cox Income** (DODIX/Intermediate-term corp.) **10% Fidelity Floating Rate High Income** (FFRHX/High-yield corp.) *In a taxable account, use **Fidelity Intermediate Municipal Income** (FLTMX) instead.