7 | BUILDING YOUR CUSTOM-TAILORED PORTFOLIO

"Nature gave man two ends—one to sit on, and one to think with. Even since then man's success or failure has been dependent on the one he used most."

– George R. Kirkpatrick (1867-1937)

Now it's time to meet the star of this book—you. Everything you've read so far is just a prelude to the main story: building the investment portfolio that's going to take you where you want to go. What will it look like? What will be in it? It's completely your call. And to help you make it, I'm going to walk you through the steps you need to consider before you start to buy assets.

We've seen that there are smart ways to invest in any asset class. And we know that combining asset classes is the best way to ensure a steady return on your investments. Further, we've learned that even volatile assets do well over time (in fact, they perform best over time).

So the strategy you follow should be a function of your investment time horizon—how many years you'll be contributing to your portfolio before you start taking money out of it—and your ability to tolerate volatility. After all, you've got to be comfortable with the decisions you make. If you had money in the market in stocks in the fall of 2008 and you were able to sleep soundly every night, you probably have a good tolerance for volatility. If you woke up and paced the floor at 3:00 A.M. each morning, you might not.

To help you decide what's best for your situation, Doug Flynn, Certified Financial Planner™, Chartered Financial Consultant, and partner and co-founder of Flynn Zito Capital Management, LLC, has worked with me to construct five model portfolios. Each portfolio corresponds to a certain set of life criteria, but the two most important determinants of the portfolio appropriate for you are age and attitude toward volatility.

There are mild-mannered individuals who wouldn't dream of playing chess without a helmet but who can handle short-term market gyrations without flinching. And there are seasoned bungee jumpers 25 years from retirement who can't accept even the possibility of losses in two consecutive quarters. So you can see that there's a psychological component to investing that overlays the rational parts of the equation.

We'll define the five investor segments by risk tolerance and portfolio objectives, like this:

Very High Risk Tolerance (Aggressive Growth)

Most suitable for those with the longest time horizon (under age 34) who focus on the highest long-term growth without regard for investment income and who can tolerate potential loss of principal in exchange for the potentially highest returns.

High Risk Tolerance (Growth)

Most suitable for those with a long time horizon (ages 35–44) who focus on strong growth without regard for investment income and who can accept some declines in value in exchange for potentially higher returns.

Moderate Risk Tolerance (Growth with Income)

Most suitable for those with a medium-term time horizon (ages 45–54) who seek moderate growth and stable income, and who can tolerate small drops in value during difficult market conditions.

Low Risk Tolerance (Income with Moderate Growth)

Most suitable for those with a shorter time until retirement (ages 55–64) who seek cautious growth and steady income and who find it difficult to tolerate portfolio declines.

Very Low Risk Tolerance (Income)

Most suitable for investors near or in retirement (ages 65+) who are focused on stability, small profits and the protection of principal.

Let's start with a simple self-test to assess which portfolio will be most appropriate for your situation. We'll call it the Velshi Volatility Test, because it will—I hope—help you make decisions from a more informed perspective.

Your investment questionnaire

The test has seven questions, and each answer is awarded one to five points. The five-point answer is always at the top of each question; the one point answer at the bottom. At the end of the test, add up your numbers and I'll tell you what they mean. Ready? Here we go.

Time horizon

1. How old are you?

a. Under age 34 (5 points)

b. 35–44 (4 points)

c. 45–54 (3 points)

d. 55–64 (2 points)

e. 65 or older (1 point)

2. When do you expect to start withdrawing from your portfolio?

a. Not for at least 20 years (5 points)

b. In 10 to 20 years (4 points)

c. In 5 to 10 years (3 points)

d. Within 5 years (2 points)

e. Immediately (1 point)

Goals and expectations

3. Which statement best describes your long-term investment objectives?

a. I'm willing to accept substantial risk and potential loss of principal in exchange for the highest potential long-term gains (5 points)

b. I want to build my nest egg and will accept some losses on the way to potentially higher returns (4 points)

c. I'm looking for a balance between growth and stability without too much fluctuation around my targeted return (3 points)

d. I want to grow with caution. I can tolerate small, short-term losses but I'm concerned about protecting my money (2 points)

e. I want to avoid losing money. My main concerns are safety and a stable return (1 point)

4. Assuming normal market conditions, what would you expect from this investment over time?

a. To generally keep pace with the stock market (5 points)

b. To slightly trail the stock market, but make a good profit (4 points)

c. To trail the stock market but make a moderate profit (3 points)

d. To have some stability but make modest profits (2 points)

e. To have a high degree of stability but make small profits (1 point)

5. Suppose the stock market performs unusually poorly over the next decade. What would you expect to happen to your portfolio?

a. It would lose money (5 points)

b. It would make very little or nothing (4 points)

c. It would eke out a little gain (3 points)

d. It would come out slightly ahead (2 points)

e. It would be little affected by what happens in the stock market (1 point)

Short-term risk attitudes

6. Which of these statements would best describe your attitude about the next three years' performance of the investment?

a. I'm in it for the long term. Whatever happens, happens (5 points)

b. I can tolerate a loss because I've got time to make it up (4 points)

c. I can tolerate a small loss (3 points)

d. I'd have a hard time tolerating any losses (2 points)

e. I need to see at least a little return (1 point)

7. Which of these statements would best describe your attitude about the next three months' performance of this investment?

a. Who cares? Three months means nothing (5 points)

b. I wouldn't worry too much about losses in that time frame (4 points)

c. If I suffered a loss of greater than 10 percent, I'd be concerned (3 points)

d. I'd be worried about any loss of more than a few points (2 points)

e. I'd have a hard time accepting any losses (1 point)

You're done! Enter total score: _____

What you've done is answered questions about three issues that affect investment decisions: time horizon, long-term goals and short-term risk attitudes. Here's how your total score matches up with our model portfolios:

32-35: *Very High Risk (Aggressive Growth) Portfolio*

25-31: *High Risk (Moderately Aggressive Growth) Portfolio*

18-24: *Moderate Risk (Growth with Income) Portfolio*

11-17: *Low Risk (Income with Moderate Growth) Portfolio*

7-10: *Very Low Risk (Income with Capital Preservation) Portfolio*

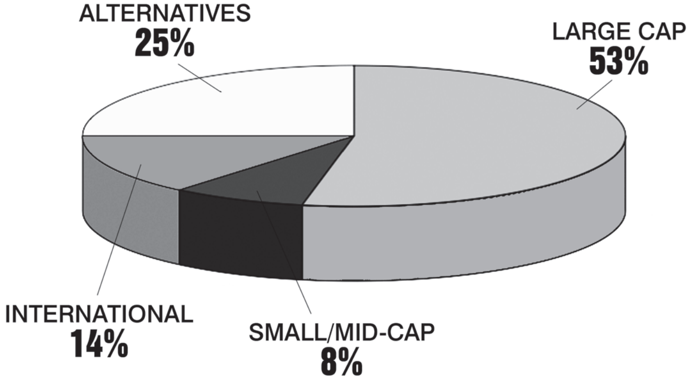
Remember, there are no right or wrong answers to any of these questions. Except for your age, the questions are completely subjective—they're about your attitudes and expectations. A further caveat is that each of us interprets words differently. One person's idea of "moderate growth" or "small losses" may be unlike another's. So this test is only a guide to get you thinking about the implications of the decisions you will make. No matter how you answered, you did great.

Your model portfolios

Now let's take a look at the portfolios that suit your risk tolerance.

While an IRA allows you to buy pretty much any regulated investment out there, your 401(k) or 403(b) investment choices will be far more limited. The names of those funds may not correspond to the categories listed here. But a quick check on Morningstar, or a call to the company that administers your plan, will tell you which funds fit into the categories you need.

VERY HIGH RISK
AGGRESSIVE GROWTH

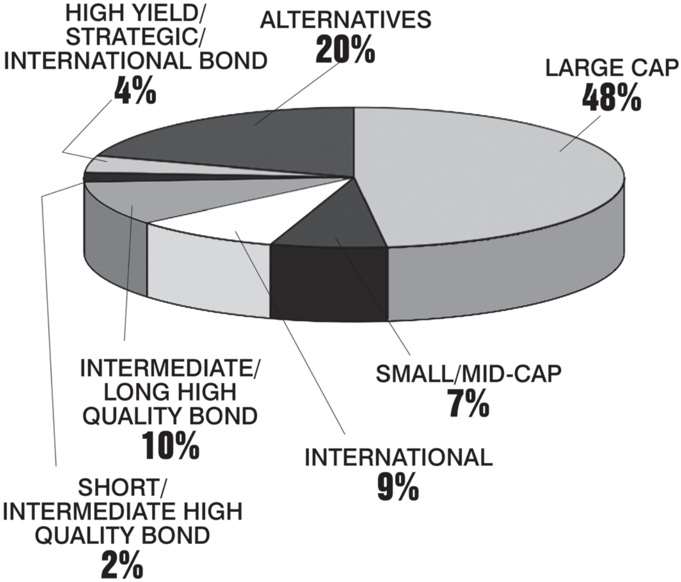


Based on historical averages this portfolio has an expected annual rate of return of

11.50%

Source: Flynn Zito Capital Management, LLC

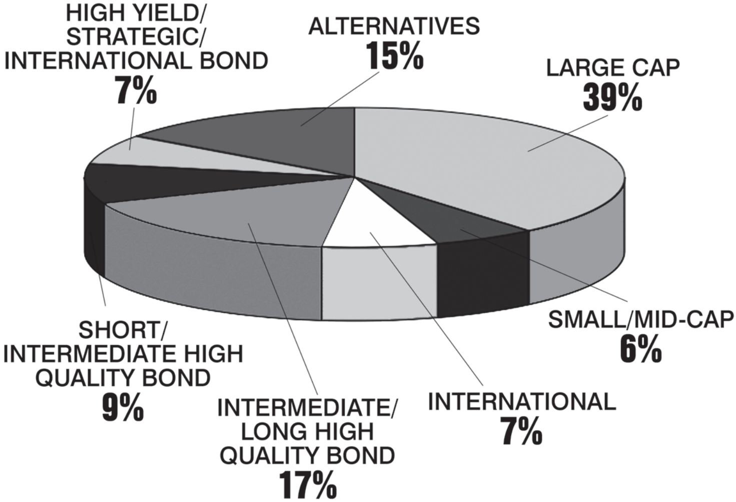
HIGH RISK
MODERATELY AGGRESSIVE GROWTH



Based on historical averages this portfolio has an expected annual rate of return of
9.75%

Source: Flynn Zito Capital Management, LLC

MODERATE RISK
GROWTH WITH INCOME



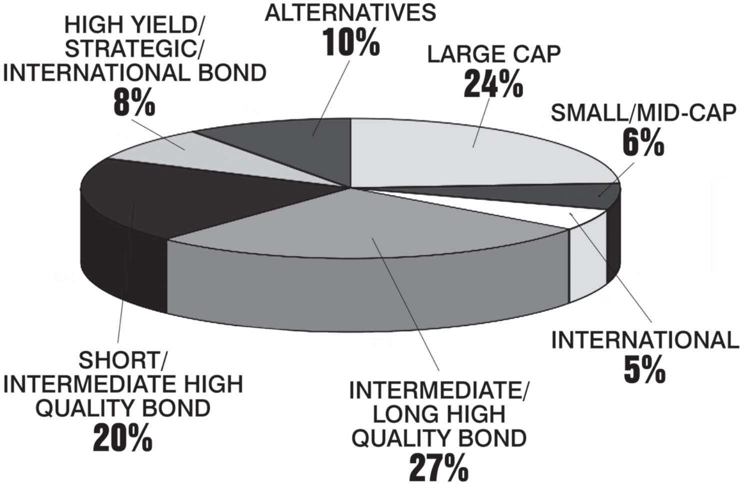
Based on historical averages this portfolio has an expected annual rate of return of

8.25%

Source: Flynn Zito Capital Management, LLC

LOW RISK

INCOME WITH MODERATE GROWTH



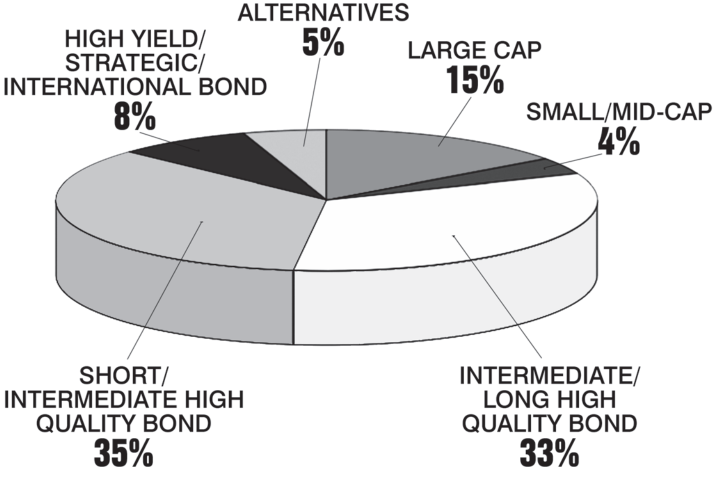
Based on historical averages this portfolio has an expected annual rate of return of

7.00%

Source: Flynn Zito Capital Management, LLC

VERY LOW RISK

INCOME WITH CAPITAL PRESERVATION



Based on historical averages this portfolio has an expected annual rate of return of

5.59%

Source: Flynn Zito Capital Management, LLC

You can see that the portfolios contain all the asset classes we've discussed, except for cash. That's because we've assumed your cash is sitting on the side, in a separate account where you can take what you need when you need it. (For beating inflation, cash doesn't work for you all that well.)

In stocks, we've diversified by both company size and by regions; within bonds, we've diversified by duration and bond quality.

You'll notice, also, that the three middle portfolios use exactly the same asset classes, but their proportions vary in order to meet the differing portfolio objectives. It's a good example of the way we're putting asset allocation to work.

In fact, we could show these allocations even more precisely. We could break down our large- and small-cap stocks into growth and value segments, and we could divide our international stocks into large and small-cap components. But for the purposes of this illustration, I thought we'd keep it on the easy-to-grasp side, more of a "this is how it's done" than an explicit "do this."

We've also used alternatives in all five portfolios. As you remember, they're great diversifiers because they're not highly correlated to stocks or bonds. And they can provide stock-like returns with bond-like volatility.

If you're setting up your portfolio as a taxable account, not a retirement account, you might want to fill the bond allocations with tax-free bonds where possible. Especially if you're in a high tax bracket. You might also consider using tax-advantaged mutual funds in the stock portion of the portfolio.

You can use these models as a general guide in creating your own portfolio. Simply fill in the slices of the pie with the investment vehicles you choose and you're on your way. They can be active funds, index funds or ETFs. You can build a portfolio from your company's 401(k) offerings.

If you're building your portfolio with mutual funds, though, remember that you might not be able to use the fund's name to determine in which "slice" it belongs. You can check Morningstar or the mutual fund screener at CNNMoney.com to see the fund's actual category.

You can—and sometimes should—have more than one fund in each category, but you should do it to diversify, not duplicate, your other holdings. For example, if you have an S&P 500 index fund, you probably don't also need a large cap stock fund. But owning both a transportation stock index fund and a retail stock index fund makes more sense, because they'll have different holdings.

The importance of rebalancing

Remember that both you and your portfolio will change as time goes by. You'll get older and your time until retirement will grow shorter. And not every slice of your portfolio pie will grow at the same rate. So it's a good idea to examine your portfolio each year and re-balance your assets in light of those changes. There are two reasons for this:

1. Your portfolio assets will grow at different rates
2. Your risk tolerance will change over time

If, for example, you allocated 8 percent to small and mid-cap stocks and they grew so fast they're now 11 percent, you'll want to take some of that money and move it so that the actual portfolio composition is in line with your objectives. It's hard to sell winners; your natural instinct is to buy more of them. But to maintain the proper portfolio balance, there will be times when you'll have to sell assets that go up and buy the ones that didn't.

If you don't think you've got the strength for counter-intuitive buying and selling, you might want to consider lifestyle and target date funds. These are mutual funds that are, in effect, model portfolios calibrated to your age. All you have to do is pick a projected retirement year and the fund managers do the rest. They adjust their asset mix as you get older, tracking you through life, dialing down the risk level as you get closer to retirement. Target-date funds can be excellent choices for people who prefer to leave decisions to the experts. The fund managers can make the tough buy and sell decisions without emotion.

It's not just your age that can change your risk profile. You'll want to adjust your portfolio mix to reflect your evolving goals. Marriage, a child, a home—life isn't static. Investing isn't static, either. So ride herd on those investments—don't let them stray off the trail.

I'd suggest you review your portfolio every quarter. Pick a comfortable time, a comfortable chair and look over your account. The key is to leave emotion out of it—whether they're up or down, quarterly returns are too short-term to get excited about. But it's important to stay involved with your finances.

After all, it's your future we're talking about. Don't make rash decisions, but don't be afraid to change. And please, don't do something just because your brother-in-law did. Your portfolio is for you. It reflects your individual situation.

While I recommend reviewing your portfolio each quarter, you may not need to rebalance it more than once a year. Needs change. You'll want to make sure your portfolio addresses the person you are, not the person you were. Each year, some fine-tuning is likely to be necessary, even if it's only to bring your current holdings into line with the allocation you established 12 months ago. In many years it will amount to little more than gardening, pruning the assets that have grown quickly and watering those that, for one reason or another, lag expectations. But in certain years you will have had major life changes, and in those cases, you'll want to revisit—and maybe revise—your asset allocation overall.

Financial advisers: yes or no?

A word here about financial advisers. The question is, "Are they worth it?" The answer, not surprisingly, is, "It depends."

That's not a cop-out. It has more to do with you than the advisor. What's interesting is that there are many areas of life where we wouldn't dream of not using a trained professional. Anyone here want to take out your own appendix? Raise your hands. I thought not.

Many of us are quite willing to hire carpenters to modernize our kitchens, golf pros to help improve our games, tutors to give our kids a better shot at Harvard and, of course, barbers and hairdressers to help us look our best.

But when it comes to the most important decisions about arguably the most important area of our lives—our futures—the attitude is often, "Why the hell should I pay some joker to do something I can do myself?"

Now, granted, there are true do-it-yourselfers in this world. They've got the *TIME Life* series of home improvement books and they can fix the bathroom sink, stop the squeak in the front door, seal the drafty window and all the rest. They not only knit their own sweaters, they shear the sheep and card the wool. They've put the household finances on Quicken and they enjoy sitting at the computer, paying the bills electronically and roaming through the fields of their orderly, buttoned-up realm.

But then there are the rest of us. We tend to go with the flow. We don't read all the instructions before we try to assemble the toy. If no one's stolen our identity, it's probably because no one's interested, not because we've been especially careful about it. When we look at what's involved in perfection, we usually decide that close enough is good enough.

Certainly the latter group, and probably the former as well, could benefit from the services of a professional who knows the terrain and whose job it is to help you stay out of the swamp and walk a safe and comfortable path to long-term financial security.

Financial planners can help you access opportunities you might not otherwise know about. They can discuss your investments with the insight and nuance gained from working with individuals at all different levels of experience and understanding. They can help you optimize your portfolio, keep you on track, coach you through the tough times and commend your ultimate success.

Many different kinds of professionals make up the universe of advisers. There are straight commission brokers, who earn a fee on every trade you make. The more you trade, the better they do. There are fee-based professionals who will manage your portfolio for a small percentage of the assets in it. There are those who charge by the hour, like an attorney, and who will listen to your questions, assess your situation and provide advice. There are discretionary managers to whom you give the power to trade on your behalf, and there are arrangements in which you must give approval to every move up front.

Only you can decide which, if any, of these avenues might make sense for you. If you're more comfortable doing your own research (and there's plenty of information publicly available) and executing your own trades, by all means do so. If you're the kind of person who would appreciate a professional point of view, well, that's certainly available too.

Before you commit to any particular adviser, here are some questions you might want to ask him or her:

1. What experience do you have?

How long has the planner been in practice? How much experience does she have helping individuals with their financial needs?

2. What are your qualifications?

Look for a planner who has proven experience in investments or retirement planning. Ask what licenses and certifications the planner holds, and what steps he takes to stay current with changes in the field. If the planner holds a financial planning designation or certification, you can check on his background with the Certified Financial Planner Board or other relevant professional organizations.

The many kinds of advisers include Certified Financial Planners™, professional or CFP® practitioners, Certified Public Accountant-Personal Financial Specialists (CPA-PFS) and Chartered Financial Consultants (ChFC). Each of these titles indicates slightly different areas of specialization and degrees of study. The most important thing, though, is that the planner has the training and skill to provide assistance in your individual case, and that planner is someone with whom you feel comfortable.

3. What services do you offer?

The services a financial planner offers depend on credentials, licenses and areas of expertise. Some planners offer advice on a range of topics but do not sell financial products. Others may provide advice only in specific areas, such as estate planning, tax matters or insurance.

4. What is your approach to financial planning?

Make sure the planner's viewpoint is neither too cautious nor too aggressive for you. Some planners require you to have a certain net worth before offering services. Find out if the planner will carry out the financial recommendations developed for you or refer you to others who will.

Most planners will ask many of the questions we've asked here. They'll want to know your goals, your risk tolerance, your personal, family and business situation. The degree of customization they offer in their planning may vary.

Some planners take a holistic approach, looking at the totality of a client's financial life—insurance, taxes, estate planning and more. Others focus exclusively on a single area, such as portfolio management. Still others put clients with similar goals, investment time horizons or wealth levels into the same "basket" of securities—essentially, model portfolios in which a few sizes fit all (as we showed last chapter). You may have to meet with several planners before you find one with the appropriate "fit" for you. Take the time to get it right.

5. *Will you be the only person working with me?*

The financial planner may work with you himself or have others assist him. You'll want to meet everyone who will be working with you. If the planner works with professionals outside his own practice (such as attorneys, insurance agents or tax specialists), get a list of their names to check on their backgrounds.

6. *How do you charge for your services?*

As part of your financial planning agreement, the planner should clearly tell you in writing how she will be compensated for the services to be provided. As we've noted, it can be via salary from the planner's company, fees, hourly rates, commissions or a combination of any and all of the above.

7. How much do you typically charge?

While the amount you pay the planner will depend on your particular needs, the financial planner should be able to provide you with a cost estimate based on the work to be performed.

8. Are there any potential conflicts of interest in our working together?

Financial planners who sell insurance policies, securities or mutual funds have a business relationship with the companies that provide these products. The planner may also receive business for referring you to an insurance agent, accountant or attorney. There's nothing necessarily bad in these arrangements; it's simply that if they exist, the planner should inform you of them.

9. What professional organizations do you belong to?

Several government and professional organizations, such as FINRA (formerly NASD), your state insurance and securities departments, and Certified Financial Planner Board keep records on financial planners and advisers. Contact these groups to conduct a background check.

There's nothing unusual in performing these checks so, please, make the calls. The planner herself may provide references for you. After all, if she's helped others succeed in the markets, isn't that a good advertisement? Conversely, if you hear damaging stories from past customers or a professional organization, you'll want to proceed with caution, if at all.

10. Can I have it in writing?

Ask the planner for a written agreement that details the services to be provided. Keep this document in your files for future reference.

By the way, a good planner will tell you most of these things without your having to ask. And almost all planners and advisers will meet with you for an introductory consultation—usually lasting about an hour—at no charge. All you'll invest, initially, is your time.

$$$ WHAT DID WE LEARN? $$$

1. Every investor is different.

Your portfolio should reflect your individual objectives and goals at a level of risk comfortable for you. It doesn't matter what others may do—it's your future and it's your call.

2. Portfolio risk tolerance is largely a function of age.

The more years you have until you'll need the money in your portfolio, the more volatility you can accept. With a longer time frame, you improve your chances for returns that meet historical long-term averages.

3. The more asset classes, the greater the diversification.

By incorporating different kinds of domestic and international stocks, bonds and alternative assets in your portfolio, you increase the chances of steady returns and give yourself access to a wider range of opportunities.

4. Rebalancing is key to staying on track.

Review your portfolio quarterly. Rebalance it once a year to keep it consistent with your objectives. Reviewing and rebalancing are the "brushing and flossing," if you will, that will keep your portfolio working hard for you.

5. Professional financial planning can help you succeed.

A good financial planner—a knowledgeable individual who understands you as a person—can bring skills to bear in helping you build for the future.

Coming up…

One step to go. With a great plan in place, all that's left is to get ready for retirement.