



FIND THE RIGHT STOCK / BOND MIX

BY CHRISTINE BENZ

Are you a stock or a bond? You may not be accustomed to comparing yourself to a financial security, but it may be useful when you're trying to figure out your portfolio's optimal stock/bond mix. The thinking goes like this: If your own earnings power, which investment researchers calls "human capital," is very stable and predictable, then you're like a bond. Think of a tenured college professor, whose income is secure for the rest of his life, or a senior who's drawing upon a pension from a financially stable company. Because such an individual has a predictable income, he could keep a larger share of his portfolio in stocks than someone with less stable human capital. He's a bond.

At the opposite end of the spectrum would be an investment broker whose income depends completely upon the stock market. When the market is going up and the broker's clients are clamoring to invest, her commissions are high and she also may earn a bonus. But when the market is down, so is her income, and her bonus may be nonexistent. She's a stock. She'd want to hold much more in bonds than stocks, because her earnings are so dependent on the stock market.

Just as our career paths affect how we view our own human capital, so do our ages. When you're young and in the accumulation phase, you're long on human capital and short on financial capital, meaning that you have many working years ahead of you but you haven't yet amassed much in financial assets. Because you can expect a steady income stream from work, you can afford to take more risk by holding equities. As you approach retirement, however, you need to find ways to supplant the income that you earned while working. As a result, you'll want to shift your financial assets away from equities and into income-producing assets such as bonds, dividend-paying stocks and income annuities.

Of course, there are no guarantees that stocks will return more than bonds, even though they have done so during very long periods of time. Over shorter time periods, stocks certainly can suffer, and

MORNINGSTAR LIFETIME ALLOCATION INDEXES: ASSET MIXES

Use these indexes to help guide your portfolio's asset allocation. Find the year closest to when you expect to retire and look for the allocation that aligns with your risk capacity.

Target Retirement Year	2060	2055	2050	2045	2040	2035	2030	2025	2020
Aggressive Allocations									
Stock %	94	94	94	94	94	91	84	75	66
Bond %	3	3	3	3	3	5	11	18	23
Inflation Hedge %	3	3	3	3	3	3	4	7	10
Cash %	0	0	0	0	0	0	0	1	2
Moderate Allocations									
Stock %	90	90	90	89	85	78	68	57	49
Bond %	7	7	7	8	11	17	25	32	35
Inflation Hedge %	3	3	3	3	3	4	7	10	13
Cash %	0	0	0	0	0	1	1	2	3
Conservative Allocations									
Stock %	83	82	81	77	68	57	46	38	32
Bond %	15	16	17	21	28	36	43	47	48
Inflation Hedge %	2	2	2	2	4	6	9	13	17
Cash %	0	0	0	0	0	1	2	2	3

Inflation hedges include inflation-protected bonds and commodities. June 2017

over periods as long as 10 years, stocks can trail bonds. For instance, from February 2002 to February 2012, U.S. stocks gained less than 5.0 percent per year on average, whereas high-quality U.S. bonds gained an average of 5.5 percent per year and endured much less volatility. Against a backdrop like that, it might be tempting to ignore stocks altogether.

At the same time, however, it stands to reason that during very long periods of time, various asset classes will generate returns that compensate investors for their risks. Because investors in stocks shoulder more risk than bondholders and bondholders take on more risk than investors in ultra-safe investments such as certificates of deposit, you reasonably can expect stocks to beat bonds and bonds to beat CDs and other "cash"-type investments during very long periods of time. In turn, that suggests that younger investors with long time frames

should have the majority of their investments in stocks, whereas those who are close to needing their money should have the bulk of their assets in safer investments such as bonds and CDs. During a 10-year period prior to December 2017, stocks, bonds and cash have settled into a more familiar pattern, with stocks outpacing bonds by 4.5 percentage points on an annualized basis, and both stocks and bonds leaving cash in the dust.

What I've discussed so far is called strategic asset allocation — meaning that you arrive at a sensible stock/bond/cash mix and then gradually shift more of your portfolio into bonds and cash as you get older. Of course, it would be ideal if we all could position our portfolios to capture stocks' returns when they're going up and then move into safe investments right before stocks go down. In reality, however, timing the market by, say, selling stocks today and then buying them back at a

later date is impossible to pull off with any degree of accuracy, so much so that most professional investors don't try it.

Maintaining a fairly stable asset allocation has a couple of other big benefits: It keeps your portfolio diversified, thereby reducing its ups and downs, and it also keeps you from getting whipped around by the market's day-to-day gyrations. An asset-allocation plan provides your portfolio with its own true north. If your portfolio's allocations veer meaningfully from your targets, then and only then should you make big changes.

To find the right stock / bond mix, you'll need:

- a list of your current investments
- an estimate of the year in which you plan to retire.
- Morningstar.com's Instant X-Ray tool, which can be found at morningstar.com/portfolio.html.

STEP 1

Before determining a target asset allocation, start by checking out where you are now. Log on to Morningstar's Instant X-Ray tool. Enter each of your holdings, as well as the amount that you hold in each. (Don't include any assets you have earmarked for short-term needs, such as your emergency fund.) Then click Show Instant X-Ray. You'll be able to see your allocations to stocks (both domestic and international), bonds, cash, and "other" (usually securities such as convertibles and preferred stock), as well as your sector and investment-style positioning.

STEP 2

The next step is to get some guidance on where you should be. Use the asset allocation in the table on this page that corresponds to your anticipated retirement date. Remember, this allocation corresponds to your long-term goals (for example, retirement assets), not your emergency fund or any shorter-term savings that you've earmarked for purchases that are close at hand.

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A KEY QUESTION TO ASK WHEN INVESTING IN BONDS

You've used asset-allocation calculators and compared your portfolio to target-date funds geared toward your retirement date. You even may have checked in with a financial adviser for a temperature check. And all systems point in the same direction: It's time to add some bonds. Check that, it's way past time to add some bonds.

But if you're like many investors, even seasoned ones who have long been navigating the stock market, you may be balking. Even if you're willing to swallow your misgivings about bonds' meager yields and the risk that rising rates could crunch bond prices, you may be dogged by a more basic issue: Where to start? The first decision bond investors must make is the delivery system: individual bonds or a bond fund? For most

investors, especially those starting out, the simplicity, diversification and professional management that come along with investing in a bond fund can be difficult to beat. But individual bonds may be appropriate in some instances. Here are the pros and cons of each strategy.

Individual bonds

Why: The key benefit of buying individual bonds is that you can readily match the bond's maturity to your time horizon. Assuming you've bought a bond from a high-quality issuer, you'll receive your coupon payments and get your principal back when the bond matures, even though interest rates may have moved up, down and sideways over your holding period.

Why not: While the marketplace for individual-bond buyers has improved

over the past decade, it still can be tricky to research individual bonds' fundamentals and determine whether the price you're paying is a fair one. This is especially true once you venture beyond government-issued and high-quality corporate bonds. Trading costs also can eat into the returns that small investors earn on individual bonds.

If you go this route for all or part of your bond exposure: Focus on very high-quality, highly liquid bonds and make sure you fully understand all of the costs and risks that come along with making the investment.

Bond funds

Why: Fund investors, even small ones, get diversification and professional management in a single shot by investing in a bond fund. And while a bond

fund may incur short-term losses when interest rates rise, the bond-fund manager will then be able to swap into new, higher-yielding bonds as they become available, thereby offsetting the hit to principal.

Why not: The fees you pay for fund management may cut into your return. And there's no guarantee you'll be able to take exactly as much out of your bond fund as you put in.

If you go this route for all or part of your bond exposure: Be sure to start building your bond-fund portfolio with core, intermediate-term funds that give you a lot of diversification in a single holding. Be careful with funds that focus on a narrow part of the market or have high costs, as high expenses correlate neatly with risk-taking among bond funds.