Give Your Portfolio a Checkup

Christine Benz
Morningstar Individual Investor Conference
March 23, 2013
Six Steps in the Portfolio Checkup Process

- Step 1: Gauge viability of your current plan
- Step 2: Evaluate portfolio positioning
- Step 3: Check liquid reserves
- Step 4: Review individual holdings
- Step 5: Troubleshoot potential risk factors
- Step 6: Conduct a cost, tax-cost audit
Step 1: Gauge Viability of Your Current Plan (Accumulators)

- Use an online calculator to gauge adequacy of current investments and savings rate.
- Thumbnail test: 12% to 15% current salary = annual savings target
- Another: 25 times current income needs = at-retirement target ($100,000 in annual income needed --> $2.5 million portfolio)
- More precise online tools include:
  - T. Rowe Price Retirement Income Calculator
  - Fidelity Retirement Quick Check
  - Fidelity Retirement Income Planner
Step 1: Gauge Viability of Your Current Plan (Accumulators)

- The best tools are holistic and factor in:
  - Inflation
  - Reasonable return expectations
  - Taxes
  - The role of other income sources such as pensions and Social Security
Step 1: Gauge Viability of Your Current Plan (Accumulators)

- Also check progress toward maxing out tax-advantaged vehicles for the year
  - 401(k) contribution limits for 2013
    - $17,500 if under 50
    - $23,000 if over 50
  - IRA contribution limits for 2013
    - $5,500 if under 50
    - $6,500 if over 50
Step 1: Gauge Viability of Your Current Plan (Retirees)

- If already retired and taking withdrawals, check viability of current withdrawal rate
- The traditional rule of thumb is that 4% with an annual inflation adjustment is a safe withdrawal rate for most
  - For someone with an $800,000 portfolio:
    - Year 1 Withdrawal: $32,000
    - Year 2 Withdrawal: $32,960 (assuming 3% inflation)
- Recent research has suggested that an even more conservative withdrawal rate (3%) makes sense given low bond yields
Step 2: Evaluate Portfolio Positioning

- Morningstar’s X-Ray tool is a good starting point
- Portfolio Manager enables you to X-Ray, as does Instant X-Ray (on Tools tab of Morningstar.com)
Step 2: Evaluate Portfolio Positioning

**Asset Allocation**

- **Long %**: Cash (3), U.S. Stocks (47), Foreign Stocks (14), Bonds (35), Other (0), Not Classified (0)
- **Total**: 100%

**Stock Style Diversification**

- **Value Core Growth**: Value (26), Core (24), Growth (21)
- **Size**: Small (6), Mid (6), Large (7)
- **Momentum**: Strong (3), Moderate (3), Weak (4)
- **Interest Rate Sensitivity**: High (21), Mod (49), Low (0)
- **Credit Quality**: High (17), Mod (0), Low (7)
- **Not Classified**: 0.00%

**Stock Sector**

- **Portfolio (% of Stocks)**: Cyclical (35.40), Basic Materials (4.81), Consumer Cyclical (11.33), Financial Services (16.69), Real Estate (2.57)
- **S&P 500 (%):** 29.94, 3.31, 10.15, 14.40, 2.08

**Stock Type**

- **Portfolio (% of Domestic Stocks)**: High Yield (5.47), Distressed (0.83), Hard Asset (11.54), Cyclic (44.87), Slow Growth (10.87), Classic Growth (0.27)
- **S&P 500 (%):** 6.41, 0.42, 12.33, 41.99, 11.99, 0.76
Step 2: Evaluate Portfolio Positioning

- Focus on asset allocation relative to your targets (Morningstar Lifetime Allocation Indexes, target date funds can be a starting point)
- Next check sector/style positioning
- Geographic exposure
- Individual stock overload
Step 2: What Should You Do If You’re Light on Stocks?

- Take comfort in the fact that stocks in aggregate aren’t notably expensive, though not cheap either (average price/fair value for Morningstar’s covered stocks = 1.01)
- Employ a dollar-cost averaging strategy, deploying fixed amounts at regular intervals
- Make sure you have a good value-oriented manager (or two) in your portfolio
- Look to Morningstar’s highly rated stocks for ideas
Step 2: What Should You Do If You’re Light on Bonds?

- Rebalance into bonds, but limit interest-rate sensitivity and keep credit quality high
- Invest with flexible core funds such as Harbor Bond (HABDX), Metropolitan West Total Return Bond (MWTRX)
- If retirement is close at hand and you’re notably underweight bonds, de-risk immediately
  - Move bond money to cash
  - Dollar-cost average over a period of months
Step 2: Evaluate Portfolio Positioning: Some Benchmarks

### Total U.S. market style

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
<th>Blend</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large</td>
<td>24</td>
<td>24</td>
<td>25</td>
</tr>
<tr>
<td>Mid</td>
<td>6</td>
<td>6</td>
<td>7</td>
</tr>
<tr>
<td>Small</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
</tbody>
</table>

### Price/fair value by style

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
<th>Blend</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large</td>
<td>0.93</td>
<td>0.99</td>
<td>1.05</td>
</tr>
<tr>
<td>Mid</td>
<td>1.03</td>
<td>1.05</td>
<td>1.10</td>
</tr>
<tr>
<td>Small</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>
Step 2: Evaluate Portfolio Positioning: Some Benchmarks

Global market cap distribution
U.S.: 46.2%
Rest of world: 53.8%
Developed markets: 88.6%
Developing markets: 11.4%
Step 3: Check Liquid Reserves

**Baseline amount if retired:**
6 months’ to 2 years’ worth of living expenses

**Baseline amount if working:**
3 to 6 months’ worth of living expenses

**Do not count:**
Residual cash in mutual funds, short-term bonds
Step 4: Review Individual Holdings

- Morningstar ratings and analyst reports enable you to quickly review status of current holdings.
- For funds, red flags include:
  - Manager, strategy changes
  - Persistent underperformance v. cheap index fund
  - Dramatically heavy stock, sector bets
- For stocks, red flags include:
  - High price/fair value
  - Negative moat trend
Step 5: Troubleshoot Potential Risk Factors

- Risk Factor 1: Potential yield-chasing in bonds, where landmines abound
  - Limited yield cushion on higher-risk bond categories
  - Excessive interest-rate sensitivity

- Risk Factor 2: Potential overvaluation in certain dividend payers
Risk Factor 1: Despite very strong equity market performance, many investors are gravitating toward bonds

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>USD Mil*</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. Stock</td>
<td>15,477</td>
<td>(116,878)</td>
<td>(7,154)</td>
<td>3,646</td>
<td>0.45</td>
</tr>
<tr>
<td>Sector Stock</td>
<td>3,961</td>
<td>2,331</td>
<td>484</td>
<td>292</td>
<td>1.38</td>
</tr>
<tr>
<td>International Stock</td>
<td>18,378</td>
<td>11,762</td>
<td>1,971</td>
<td>1,446</td>
<td>1.31</td>
</tr>
<tr>
<td>Balanced</td>
<td>7,133</td>
<td>19,790</td>
<td>1,377</td>
<td>912</td>
<td>0.81</td>
</tr>
<tr>
<td>Taxable Bond</td>
<td>31,000</td>
<td>263,038</td>
<td>17,094</td>
<td>2,530</td>
<td>1.24</td>
</tr>
<tr>
<td>Municipal Bond</td>
<td>7,122</td>
<td>50,037</td>
<td>1,436</td>
<td>594</td>
<td>1.22</td>
</tr>
<tr>
<td>Alternative</td>
<td>2,719</td>
<td>13,819</td>
<td>1,272</td>
<td>94</td>
<td>3.00</td>
</tr>
<tr>
<td>Commodities</td>
<td>749</td>
<td>689</td>
<td>686</td>
<td>52</td>
<td>1.49</td>
</tr>
<tr>
<td><strong>All Long Term</strong></td>
<td><strong>86,540</strong></td>
<td><strong>244,588</strong></td>
<td><strong>17,166</strong></td>
<td><strong>9,565</strong></td>
<td><strong>0.93</strong></td>
</tr>
<tr>
<td>Money Market</td>
<td>(3,455)</td>
<td>10,438</td>
<td>(13,808)</td>
<td>2,536</td>
<td>(0.13)</td>
</tr>
</tbody>
</table>
Unfortunately, investors’ timing has often been wide of the mark

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>US Stock</td>
<td>10.04</td>
<td>9.80</td>
<td>0.24</td>
<td>1.55</td>
<td>0.75</td>
<td>0.80</td>
<td>7.89</td>
<td>6.88</td>
<td>1.01</td>
</tr>
<tr>
<td>Sector Stock</td>
<td>9.28</td>
<td>8.26</td>
<td>1.02</td>
<td>1.54</td>
<td>1.07</td>
<td>0.47</td>
<td>9.44</td>
<td>9.07</td>
<td>0.37</td>
</tr>
<tr>
<td>Intl Equity</td>
<td>5.18</td>
<td>5.10</td>
<td>0.08</td>
<td>-2.43</td>
<td>-3.01</td>
<td>0.58</td>
<td>9.95</td>
<td>6.84</td>
<td>3.11</td>
</tr>
<tr>
<td>Balanced</td>
<td>7.49</td>
<td>7.72</td>
<td>-0.23</td>
<td>2.08</td>
<td>2.49</td>
<td>-0.41</td>
<td>6.37</td>
<td>5.53</td>
<td>0.84</td>
</tr>
<tr>
<td>Taxable Bond</td>
<td>6.94</td>
<td>5.75</td>
<td>1.19</td>
<td>5.80</td>
<td>5.16</td>
<td>0.64</td>
<td>5.63</td>
<td>4.76</td>
<td>0.87</td>
</tr>
<tr>
<td>Muni Bond</td>
<td>5.91</td>
<td>4.49</td>
<td>1.42</td>
<td>4.71</td>
<td>3.33</td>
<td>1.38</td>
<td>4.06</td>
<td>2.71</td>
<td>1.35</td>
</tr>
<tr>
<td>All Funds</td>
<td>7.59</td>
<td>7.36</td>
<td>0.23</td>
<td>2.02</td>
<td>1.49</td>
<td>0.53</td>
<td>7.05</td>
<td>6.10</td>
<td>0.95</td>
</tr>
</tbody>
</table>
And the bond categories investors have been buying have seen their yields decline as they’ve grown more popular.

<table>
<thead>
<tr>
<th>High-Yield Bond Funds</th>
<th>Emerging Markets Bond Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-Year Inflow: $13.4 bil</td>
<td>1-Year Inflow: $22.1 bil.</td>
</tr>
<tr>
<td>Current Yield: 6.2%</td>
<td>Current Yield: 4.5%</td>
</tr>
<tr>
<td>2008 Return: -24%</td>
<td>2008 Return: -26%</td>
</tr>
</tbody>
</table>
Some investors may be looking for income without due attention to the downside.

<table>
<thead>
<tr>
<th>Bank Loan Funds</th>
<th>Multisector Bond Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-Year Inflow: $20.7 bil.</td>
<td>1-Year Inflow: $24.9 bil.</td>
</tr>
<tr>
<td>Current Yield: 4.7%</td>
<td>Current Yield: 4.4%</td>
</tr>
<tr>
<td>2008 Return: -17%</td>
<td>2008 Return: -15%</td>
</tr>
</tbody>
</table>
High-quality bonds carry risks of their own: greater interest-rate sensitivity

- The Fed has set its sights on fighting unemployment
- If the economy continues to improve, interest rates could begin to trend up
- Consider the following “duration stress test”
  - Fund’s duration minus fund’s SEC yield = expected loss over one-year period if interest rates rose by 1 percentage point
  - Stress test most useful for high-quality bond types, less useful for junk bonds, international bonds, etc.
Stress Test Examples

- Vanguard Total Bond Market Index
  - Duration of 5.2 years minus SEC yield of 1.6% = ~3.6% loss if rates rose by 1 percentage point

- Vanguard Long-Term Bond Index
  - Duration of 14.7 minus SEC yield of 3.7% = ~11% loss if rates rose by 1 percentage point
Risk Factor 2: Potential overvaluation in the dividend patch?

Economically Sensitive (1.00)
- Communications Svc. P/FV: 0.87
- Energy P/FV: 0.92
- Industrials: 1.05
- Technology: 1.02

Cyclical (1.01)
- Basic Materials: 0.91
- Consumer Cyclical P/FV: 1.04
- Financial Services P/FV: 1.00

Defensive (1.05)
- Consumer Defensive P/FV: 1.08
- Utilities P/FV: 1.05
- Health P/FV: 1.01
- Real Estate 1.06

Sector Valuation graph available on Stocks cover page.
Step 6: Conduct a Cost, Tax-Cost Audit

- Total portfolio cost audit: Compare your portfolio’s expense ratio (in X-Ray) to that of a good target-date fund for your age range.
- Expense ratio for T. Rowe Price Retirement 2025: 0.73%
- Expense ratio for Vanguard Target 2025: 0.17%

### Fees & Expenses | Holdings Detail

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Mutual Fund Expense Ratio (%)</td>
<td>0.79</td>
</tr>
<tr>
<td>Expense Ratio of Similarly Weighted Hypothetical Portfolio (%)</td>
<td>1.22</td>
</tr>
<tr>
<td>Estimated Mutual Fund Expenses ($)</td>
<td>15,052.29</td>
</tr>
<tr>
<td>Total Sales Charges Paid ($)</td>
<td>0.00</td>
</tr>
</tbody>
</table>
Step 6: Conduct a Cost, Tax-Cost Audit

- Holdings-level cost audit for index funds, ETFs.
- ETF price wars have been good for consumers
- Are your holdings as cheap as the cheapest funds available to retail investors in each asset class?
  - Domestic Stock: 0.04%
  - International Stock: 0.09%
  - Bond: 0.05%
Step 6: Conduct a Cost, Tax-Cost Audit

- If you’re in accumulation mode, are you adhering to most, if not all, of these “best practices” for tax management?
  - Making maximum contributions to tax-sheltered accounts
  - Using “asset location” principles to hold tax-inefficient assets (junk bonds, REITs, etc.) in tax-sheltered accounts
  - Steering tax-efficient investments toward your tax-sheltered accounts: individual stocks, broad stock market index funds and ETFs, municipal bonds/funds
Step 6: Conduct a Cost, Tax-Cost Audit

- If you’re retired, are you adhering to most, if not all, of these “best practices” for tax management?
  - Contributing to Roth IRA if you have earned income
  - Using “asset location” principles to hold tax-inefficient assets (junk bonds, REITs, etc.) in tax-sheltered accounts
  - Sequencing withdrawals to reduce tax drag on your investments: RMDs, taxable accounts, tax-deferred accounts, and Roth accounts bringing up the rear
  - Strategizing about which accounts you tap for income on a year-to-year basis to stay in the lowest possible bracket