

# PORTFOLIO STRATEGIES

## Recommended Reading: Four Books That Cover It All

By William Reichenstein

**T**hrough the decades, Bob and Betty Smith have acquired a healthy financial portfolio worth about \$1.5 million.

They owe their success to three factors. First, they have saved diligently, especially in the most tax-advantaged savings vehicles like the Roth IRA and 401(k).

Second, they selected and maintained a target asset allocation with a healthy allocation to stocks. While in their 30s, their stock allocation was about 90%, but it has slowly decreased through the years and at their current age of 60 it is about 55%.

Third, they have kept investment costs low by investing in no-load low-cost mutual funds and through discount brokerage services. Currently, the total annual cost of financial services is 0.5%, which includes mutual funds' management expenses plus transaction costs. These three factors have led to their financial success.

But it is not the end of the story.

Based on his background, Bob has made the investment decisions. Although he has informed Betty of his decisions along the way, Betty has relied on his judgments.

Looking at their financial situation, Bob feels a bit smug. Although he does not plan to retire for five or six years, he is confident that their nest egg will be sufficient to support their retirement plans.

Furthermore, should he die he is confident that the current nest egg should support his wife. Based on a conservative withdrawal rate of 4%, the financial portfolio would almost certainly support a constant annual income of \$60,000 a year



in today's dollars for the rest of Betty's life even if she should live into her 90s. [See "Retirement Savings: Choosing a Withdrawal Rate That Is Sustainable" and "Retirement Withdrawals: What Rate Is Safe When Time Is Short and Uncertain?" by Cooley, Hubbard, and Walz in the February 1998 and January 2005 issues, respectively, of the

*AAIL Journal*, available at [AAIL.com](http://AAIL.com).] Moreover, she would be entitled to Social Security income of \$20,000 in today's dollars. The \$80,000 real income should be more than sufficient to meet her needs.

But then Betty told him that if something happened to him, she would seek financial help. If she hires a financial planner, she can expect to pay 1% a year for the advice. Assuming the fee-only planner would utilize low-cost funds, hiring the planner would raise costs by about \$15,000 a year (or 1% of \$1.5 million), which would reduce the real income from the financial portfolio from \$60,000 to \$45,000.

If she goes to a broker, she may pay an additional 2% a year in costs, which would cut the \$60,000 a year in half to \$30,000.

What at first glance was a secure retirement for his wife is less certain if she would need to rely on financial assistance.

In frustration, Bob searches for a solution. Where can his wife get sound financial advice but avoid the costs of attaining it?

The goal of this article is to provide a list of books and

journalists that should help Betty and the millions like her feel confident in managing their own portfolios.

## Recommended Books

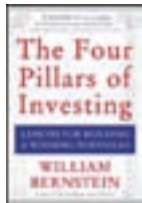
Although there are numerous good books, I tried to limit my recommendations to the crème de la crème in two areas: general “how to invest” books, and those that focus specifically on retirement plans.

### General “How to” Books

As readers of my work might suspect, I selected books that do a good job of helping individuals:

- 1) Decide their target asset allocations, and
- 2) Encourage the selection of no-load low-cost mutual funds or exchange-traded funds (ETFs).

Another selection criterion was to limit books to those that are easily readable. Here are my top three selections.



William J. Bernstein, **“Four Pillars of Investing: Lessons for Building a Winning Portfolio,”** McGraw-Hill, 2002

“Four Pillars” is organized around the theory, history, psychology, and business of investing. Much of the asset allocation advice is in Chapter 13, “Defining Your Mix.”

Bernstein says an adequate portfolio need contain only three broad asset classes: U.S. total stock market, international stocks, and short-term U.S. bonds. For the U.S. stock portion, he recommends five asset classes: large-cap, small-cap, large-cap value and small-cap value, and real estate investment trusts (REITs). Since large value and small value indexes tend to contain both value and blend stocks, his value tilt is more precisely a tilt against growth stocks.

For the bond portfolio, his overriding principle is to select short-term—five years or less—high-grade bonds. One solution would be to buy two-year Treasuries direct from the government

at auction, thereby minimizing investment expenses.

Concerning the selection of mutual funds, he recommends only no-load low-cost funds, primarily index funds. He provides a list of recommended funds by asset class.

The theory section emphasizes the long-run connection between risk and return. The history section notes the tendency for financial markets to go berserk about once a generation, and the need to keep your wits about you during these episodes. The psychology section reviews key psychological mistakes many investors make and how to avoid them.

The section on the business of investing is worth the price of the book. A chapter entitled “Your Broker Is Not Your Buddy” warns that “under no circumstances should you have anything to do with a ‘full-service’ brokerage firm.” The next chapter entitled “Neither Is Your Mutual Fund” explains the chicanery that goes on at some mutual fund families.

For additional information, visit the author’s Web site at [www.efficientfrontier.com](http://www.efficientfrontier.com).

William Bernstein has also written “The Intelligent Asset Allocator” (McGraw-Hill, 2000). It covers most of the same topics but at a more rigorous level.



Burton G. Malkiel, **“A Random Walk Down Wall Street,”** 8th Edition, W.W. Norton and Company, 2004

“Random Walk” is in its 8th edition and is considered an investment classic.

Malkiel’s basic premise is: Since financial markets are highly efficient, investors would be better off buying and holding an index fund than attempting to buy and sell individual securities or actively managed mutual funds.

Concerning asset allocation, on pages 350-351 he provides a life-cycle investment guide that provides model portfolios of cash, bonds, stocks, and

real estate (or REITs) for typical individuals by age. The model portfolios are for investors in their mid-20s, late 30s to early 40s, mid-50s, and late 60s and beyond. Excluding real estate, the target stock allocations are 65%, 55%, 45%, and 25% for each group respectively. Including real estate as stocks, the target stock allocations decrease from 75% for the youngest investors to 40% for the oldest investors. Furthermore, in personal correspondence Mr. Malkiel told me that, due to longer life expectancies, in the next edition he will raise the stock (including real estate) allocation to 50% for the late-60s-and-beyond age group.

For the U.S. portion of the stock portfolio, Malkiel advocates a simple two-prong approach. First, invest in a total stock market index fund (instead of a large-cap fund like one that follows the S&P 500) to provide a good exposure to smaller-cap stocks. Second, invest in a real estate fund to provide exposure to this asset class and to tilt the portfolio toward value stocks.

For individuals seeking the ultimate in simplicity, on page 364 he recommends a specific index-fund portfolio for a mid-50s investor, and the same funds could be used with the different weights for individuals at other ages. He provides separate lists of no-load low-cost mutual funds for U.S. stocks, international stocks, real estate, taxable bonds, tax-exempt bonds, taxable money funds, and tax-exempt money funds.

This book has several great attributes. It is extremely easy to read and the author has injected much humor into it. For example, in a chapter on technical analysis he relates funny stories that ridicule technical analysts and eschew market timing, while providing lessons that are designed to protect your nest egg.

In a chapter entitled “A Fitness Manual for Random Walkers,” the book goes beyond investments to provide advice on financial planning topics such as the need to “cover thyself with protection,” to “know your investment objectives,” to “remember ... costs,” and to

“diversify your investment steps.”

All in all, this book lives up to the author’s claim that it “remains fundamentally a readable investment guide for individual investors.”



Larry E. Swedroe, **“The Only Guide to a Winning Investment Strategy You’ll Ever Need,”** St. Martin’s Press, 2005

The book’s goal is to “help investors understand how to apply the principles of [modern portfolio theory] MPT and the [efficient markets hypothesis] EMH to their own unique circumstances and personalities.” It uses analogies to sports, history, and more to explain difficult concepts. It advocates broad diversification and low-cost passive management. It is designed to be an intelligent investor’s road map to a long-term winning investment strategy.

Concerning asset allocation, Swedroe believes in broad diversification across U.S. stocks, international stocks, and U.S. bonds. He presents four model portfolios, from a conservative 40% stock/60% bond allocation to a highly aggressive 100% stock allocation. In each portfolio, he recommends that 30% of the stock portion be dedicated to international stocks including emerging markets, and he advocates small-cap and value tilts for domestic and international stocks. For the bond portion he recommends high-grade short-term bonds. Concerning expenses, he advocates no-load, low-cost passive management, such as index funds and exchange-traded funds.

This book has other valuable features. In addition to providing model portfolios, it provides guidance in helping someone select the best portfolio for his or her risk tolerance. In particular, it distinguishes among an investor’s willingness, ability, and need to take risk and how these factors should affect an investor’s risk tolerance. It provides a list of recommended funds by asset class and provides sample portfolios.

The book also discusses more ad-

vanced topics, like asset location—the decision to hold bonds in retirement accounts and stocks in taxable accounts or vice versa.

In comparison with the prior two recommended books, the Swedroe book spends more time discussing findings from academic and professional literature, and may be best suited for someone who enjoys a bit of intellectual rigor. But a prior investment background is not needed.

## Retirement Plans Book

There is one book in this category.



Ed Slott, **“The Retirement Savings Time Bomb and How to Defuse It,”** Viking Penguin, 2003

Most people have substantial funds in traditional IRAs defined broadly to include all tax-deferred accounts such as 401(k), 403(b), 457, Keogh, SEP-IRA and SIMPLE IRA. This book is designed to protect “the assets you’ve spent a lifetime building from excessive taxation.”

The Slott book walks you through “five easy steps to protect your retirement savings from the taxman.”

Step 1 describes distribution requirements from traditional IRAs including the required beginning date and required minimum distributions.

Step 2 examines whether you need life insurance to cover estate taxes at death.

Step 3 explains the mechanics and benefits of a “stretch IRA” which allows distributions to be stretched out for as long as possible—e.g., over your children’s or grandchildren’s life expectancies—to maximize the benefits of tax-deferred growth.

Step 4 explains the benefits of Roth IRAs including the advantages of converting a traditional IRA to a Roth IRA.

Step 5 discusses estate taxes.

Not surprisingly, the interaction of

all these features can be confusing, but Slott does an excellent job of walking you through the strategies and trade-offs. For example, large IRA owners may want estate tax exemption, a stretch IRA option, and control over assets. He explains how you can attain any two, and presents a recommended trade-off that would best serve many individuals.

One of the advantages of a book like this is that you can skim parts that do not apply to you and concentrate on the parts that do. That fact plus the author’s jocular writing style make the book palatable. For someone interested in maximizing the benefit of their retirement accounts for later generations, it is downright tasty!

## Recommended Journalists

In my family, we periodically enjoy a Boys Day at the Races. Before this year’s outing, I bought the Daily Race Form, armed myself with the newspaper’s predictions, acquired copies of the Expert’s Tips, Gold Sheet, and, my favorite, the Professor’s Predictions—if I can’t trust a fellow prof, who can I trust! I read about hot jockeys and trainers. Headlines boasted of high winning percentages! I was promised more “smart plays” than I could afford to bet on.

Alas, I managed to lose my limit!

There are eerie similarities between the advice surrounding horse markets and financial markets.

You can read stock picks from scores of hot managers, each of which is confident that he or she will beat the market. Magazine headlines promise you the “keys to success in soft markets,” tell you how to profit from “exotic metals markets,” and provide a list of “the best mutual funds.” You can read interviews with hot managers. Newspapers herald a firm’s quarterly earnings surprise and discuss the recent expansion at a local plant. Advertisements boast of high returns! You are promised more “smart plays” than you could afford to bet on.

I long ago learned to ignore these headlines and stories. Investment magazines report yesterday’s winners,

## Recommended Books

### General “How-To” Books

William J. Bernstein, **“Four Pillars of Investing: Lessons for Building a Winning Portfolio,”** McGraw-Hill, 2002, \$29.95

#### Highlights

*Diversify Among Major Asset Classes:* U.S. total stock market, international stocks, and short-term U.S. bonds.

*Stock Portfolio:* Large caps, small caps, and REITs, with a tilt toward value.

*Bond Portfolio:* Short-term (five years or less) high-grade bonds.

*Model Portfolios:* Provides separate model portfolios for investors with taxable assets and investors with tax-sheltered assets. For taxable portfolios: 40% total stock market index, 20% tax-managed small cap, 25% tax-managed international, and 15% REITs. For tax-sheltered portfolios: 20% S&P 500 index fund, 25% value index, 5% small-cap index, 15% small-cap value index, 10% REIT index, 3% precious metals, 5% European, 5% Pacific, 5% emerging markets, and 7% international value.

Burton G. Malkiel, **“A Random Walk Down Wall Street,”** 8th Edition, W.W. Norton & Company, 2004 paperback, \$17.95.

#### Highlights

*Diversify Among Major Asset Classes:* Cash, bonds, stocks, and REITs.

*Stock Portfolio:* A total stock market index fund and a REIT.

*Model Portfolios:* Stock portion (including REITs) ranges from 75% for the youngest investors to 40% for the oldest investors (but will increase to 50% in next edition).

Larry E. Swedroe, **“The Only Guide to a Winning Investment Strategy You’ll Ever Need,”** St. Martin’s Press, 2005, \$25.95

#### Highlights

*Diversify Among Major Asset Classes:* U.S. stocks, international stocks, and U.S. bonds.

*Stock Portfolio:* Tilt toward small-cap and value stocks for both U.S. and international stocks. Also, 30% of stock portfolio should be international, including emerging markets.

*Bond Portfolio:* High-grade short-term bonds.

*Model Portfolios:* Range from 40% stock/60% bond allocation (conservative) to 100% stock allocation (highly aggressive).

### Retirement Plans Book

Ed Slott, **“The Retirement Savings Time Bomb and How to Defuse It,”** Viking Penguin, 2003 paperback, \$15.00

Scott Burns’s columns are entertaining and educational.

### Jonathan Clements

Clements is a columnist for the Wall Street Journal. He writes the “Getting Going” column in the Wednesday edition and a column that appears in the Sunday edition of the Wall Street Journal and is published in 80 newspapers around the country. Clements is an

advocate of efficient markets. He favors a cost-conscious passive management style, including the use of index funds and exchange-traded funds. He chides those who push high-cost investment products and high-priced financial advisors. He emphasizes broad diversification, including international diversification. And he encourages readers to use the tax code to their advantage by maximizing savings in Roth IRAs and

not tomorrow’s winners. Newspapers report business news, not investment insights. In general, these stories and advertisements contain little useful information for the investor. A prudent long-term investment strategy does not change with the season or even from year to year.

Although I ignore most of the financial press, here are a few exceptions.

### Scott Burns

Mr. Burns is a columnist for the Dallas Morning News, but his columns are syndicated to about three dozen newspapers and electronic media from Boston to Seattle. Burns writes about a host of financial planning topics: when to begin Social Security payments, the merits of immediate annuities, the need for insurance, and why retirement living costs may be lower than you think. He pushes the importance of controlling investment expenses, and is not afraid to attack the merits of a typical variable annuity, an indexed annuity, and other high-cost products.

Since 1991, he has heralded the merits of the Couch Potato Portfolio, a portfolio containing a 50%/50% mix of one U.S. stock index fund and one bond index fund. Through the years, he has suggested a 75% stock/25% bond mix for more aggressive, yet slothful, investors. But the idea remains to keep things simple and cheap. The Couch Potato Portfolios have fulfilled their promise of providing “a sure-fire formula to invest your money and enjoy a return that will put you in the top half of all professional investors.”

About two years ago, just as I was getting impatient with the lack of international stocks in the Couch Potato approach, Burns introduced the Margarita Portfolio. A tribute to “the Other Buffett”—Jimmy—it calls for an equal mix of index funds that follow the domestic total stock market, EAFE (international developed stocks), and Treasury Inflation-Protected Securities (TIPS). Like the Couch Potato portfolios, it offers broad diversification and low costs.

401(k)s, saving for college in low-cost 529 plans or by placing assets in your child's name, and allowing capital gains to grow unharvested. He evaluates Web tools that will help investors manage their money. And he concentrates on the big picture and the factors that individuals can control.

Based on readers' comments mentioned in his column, some readers get tired of reading the same old messages. But there are relatively few lessons that an investor really needs to learn. Every Wednesday morning, I look forward to an enjoyable and enlightening read.

### Other Writers to Consider

Two of the book authors discussed above assured me that Jason Zweig, columnist at Money, deserves to make this short list. Also, when traveling, I have read and enjoyed a column entitled Ask Humberto, a syndicated newspaper column written by Humberto Cruz. Unfortunately, I have not read these writers' work frequently enough to offer a strong personal opinion.

### Betty's Dilemma

To effectively manage her financial portfolio, Betty Smith (and the millions like her) will need to:

- 1) set her target asset allocation,
- 2) select mutual funds or ETFs to fill each asset class, and
- 3) keep her actual asset allocation near its target allocation.

The last step should be easy. Consequently, in practice, Betty's two key decisions are to set her target asset

allocation and select mutual funds or ETFs to fill each asset class. Any of the three "general how-to" books should help her perform these two duties. Philosophically, they each advocate the advice of modern portfolio theory and efficient markets hypothesis: Hold a broadly diversified portfolio and keep costs to a minimum.

If financial markets were not reasonably efficient, then to attain competitive returns Betty would need to consider several difficult questions. Will the dollar rise or fall, and how far? How far will the Federal Reserve raise interest rates? How high will oil prices go, and what effect will that have on consumer spending? In short, what will tomorrow look like and what will individual securities be worth then?

These are tough questions. Feeling incapable of answering them leads many investors to seek financial assistance.

Ironically, it is because there are so many bright professional investors trying to anticipate what tomorrow will look like that Betty does not need to answer the tough questions. The natural consequence of investors' actions is that, in general, security prices should be fairly valued. Betty need not and, indeed, should not try to answer the tough questions unless she thinks she can answer them better than professional investors. Instead, a prudent strategy is for Betty to assume that securities are reasonably priced and thus hold a broadly diversified portfolio, while minimizing expenses. The existence of reasonably efficient financial markets is a liberating force: It makes it relatively easy

for Betty and the legions of financially unsophisticated investors to prudently manage their portfolios.

There may be good reasons for Betty to seek financial assistance. She may need estate planning help, or she may need help to set up a trust to meet a special need. In addition, a good financial adviser—and not all are good—can help her add value through tax-efficient management and related issues that I addressed in articles in the February, July, and November 2005 issues of the *AII Journal* [available at AII.com].

However, it is not clear that the collective value of these recommendations will exceed the typically 1% per year cost of hiring a fee-only financial planner—and the total costs of other financial advisers is usually higher.

On a personal front, should something happen to me, I would hope my wife would follow the efficient-markets advice offered in the recommended books and would manage the portfolio herself. In addition, I would hope that she would read my 2005 *AII Journal* articles and incorporate some of these ideas. If she would find the financial portfolio to be more than sufficient to meet her retirement needs, then I would hope that she would read Slott's book and help pass the surplus to the next generation tax-efficiently. Unless she had special financial planning needs, I would hope that my wife would not hire a financial adviser.

You see, although the specifics have been fudged, "Betty" and "Bob" are my wife and me... We are much younger, of course! ▲

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