

RETIREMENT READY

In this new economic world, **how should your portfolio change** as you approach retirement? Here's what the experts say.

Constructing a retirement portfolio used to be simple. You would subtract your age from 100 to determine the percentage of stocks to hold, and then buy a mix of U.S. stocks, mostly blue chips. After that, you could add some government and investment grade bonds and call it a day.

But the last decade has transformed the consensus about how investors should allocate their assets for retirement. Asset classes previously unseen in retirement portfolios—commodities, real estate, foreign bonds and hedge funds—are now considered essential to mitigate risk and provide opportunities for growth. Particularly after the economic crisis of 2008, “there’s been a tremendous shift,”

says Mark Germain, CEO of Beacon Wealth Management in Glen Rock, N.J. “People had become deluded that their money would grow no matter what. Now they say, ‘I need to actually plan my retirement portfolio.’”

The biggest transformation stems from globalization. With the U.S. economy expected to lag global growth for the foreseeable future, investors need to look abroad. Once considered too risky for the average investor, emerging markets now make up more than 10 percent of many asset allocation models. Most advisors recommend about 25 percent to 35 percent in foreign stocks, but at some firms total exposure to non-U.S. stocks now matches or exceeds U.S. holdings.

Fixed-income portfolios have also undergone a transformation. With the U.S. bond market ending a 30-year bull run and interest rates poised to rise, advisors have pared back their core bond portfolios of government and investment-grade bonds to make way for more foreign bonds, from sovereign high-quality bonds to emerging market debt.

“Fixed income portfolios of U.S. investors have historically been tied to U.S. interest rates, but we’re now diversifying away from that,” says Laura Thurow, co-director of private wealth management research at Robert W. Baird & Co. Emerging market bonds, floating rate loans and mortgage-backed securities are often found in the fixed income baskets.

65

55

45

35

25

70/24/6

80/14/6

45/45/10

45/30/25

55/25/20

80%
STOCKS

- > U.S.: 50%
- > Foreign developed: 15%
- > Emerging markets: 15%

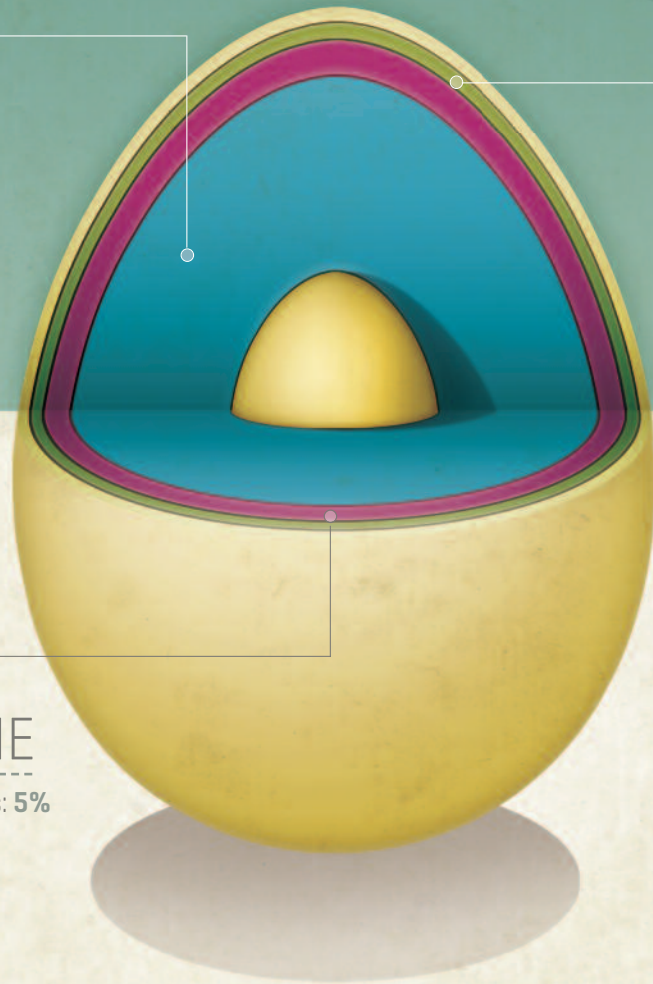
6%
ALTERNATIVES

- > Commodities: 3%
- > Real estate: 3%

AGE 25

14%
FIXED INCOME

- > Investment-grade bonds: 5%
- > High yield: 7%
- > Foreign bonds: 2%



And while old-school portfolios were divided between stocks and bonds, now advisors make room for a healthy dose of alternative investments. Commodities and real estate have a place even for investors with modest asset levels. For those with bigger portfolios who can handle illiquid investments and stiff minimums, hedge funds, private equity, master limited partnerships and other alternatives should be included.

Portfolio risk is now commonly measured in terms of the percentage of risky assets held versus conservative ones, rather than the traditional breakdown between stocks and bonds. For example, a portfolio for a mid-career professional with two decades to retirement may have just 55 percent in stocks. That may seem like a small

dose, but when you factor in 20 percent in alternative investments and 10 percent in high-yield bonds, the portfolio appears far more aggressive.

Commodities, both domestic and foreign, are a prime example of a new asset class for the average investor, says David Campbell, principal at Bingham, Osborn & Scarborough in San Francisco. "Ten years ago, you could invest in single types of commodities, typically in a futures format. Today you have mutual funds and ETFs that invest in single commodities and in baskets of commodities."

Another watershed change means managing portfolios more aggressively. "It used to be you would buy IBM and sit on it and wait for dividends," Germain says. "Now investors need to be ready to make

changes based on what's happening in the market."

How should you create your retirement portfolio? Advisors recommend first establishing a strategic long-term asset allocation, based on goals and risk tolerance. Then, create shorter-term tilts—a tactical allocation—to reflect trends in various asset classes. For example, Citi Private Bank's long-term recommendation for a maximum-growth portfolio is to put 11 percent in emerging market stocks. But as of this writing, due to concerns about valuations and inflationary pressures in developing nations, the tactical allocation is for 6 percent.

The strategy is not the same as market timing, Germain insists. "It's taking advantage of opportunities in

the market." The tactical portfolios may stay in place for several months or more than a year; they are not to be tinkered with daily or weekly based on newspaper headlines.

What balance investors strike between asset classes depends on wealth levels, goals, time horizon and risk tolerance. Here is one look at how investors may position portfolios in the decades before retirement, with asset allocation changes evolving gradually over a period of years. (Consider this a suggestion, not a mandate; though these portfolios reflect the consensus opinion of the advisors with whom I spoke, there's plenty of room for disagreement.)

The progression assumes that by age 65, the portfolio would have to start generating income, and that invested assets grow over the years from a modest starter portfolio at age 25 to several hundred thousand dollars by age 35 and well more than \$1 million by age 45. It also assumes that investors keep cash to cover short-term needs.

AGE 25

At this career- and income-building age, investors have two basic goals: Max out savings and grow them aggressively. This means putting about 70 percent to 90 percent of your assets into the stock market, says Rick Ferri, CEO of Portfolio Solutions in Troy, Mich. That doesn't mean you should buy individual stocks, Ferri says; dollar-averaged, low-cost index and exchange-traded funds will better benefit most investors, who tend to time market purchases and sales poorly.

If the volatility of the past few years gives you pause, consider this: Since 1926, the average recovery from a 10- to 20-percent stock market decline has been less than four months, according to Sam Stovall, chief investment strategist at Standard & Poor's. Tough as the

downdrafts may feel, with retirement still some 25 to 45 years off there is plenty of time to make up for temporary declines. For people in their 20s, a market slump is nothing more than a buying opportunity.

Over time, the return on stocks is hard to beat. Since 1926, the average annual return is on stocks is 9.9 percent, compared to 5.5 percent for a core bond portfolio, according to Ibbotson Associates, a market-tracking firm.

In the earlier stages of building wealth, alternative investments should be held to a minimum. Hedge funds and private equity funds—which come with high minimum investments—

probably aren't within reach, and the fee/ROI ratio may not justify investing in them anyway.

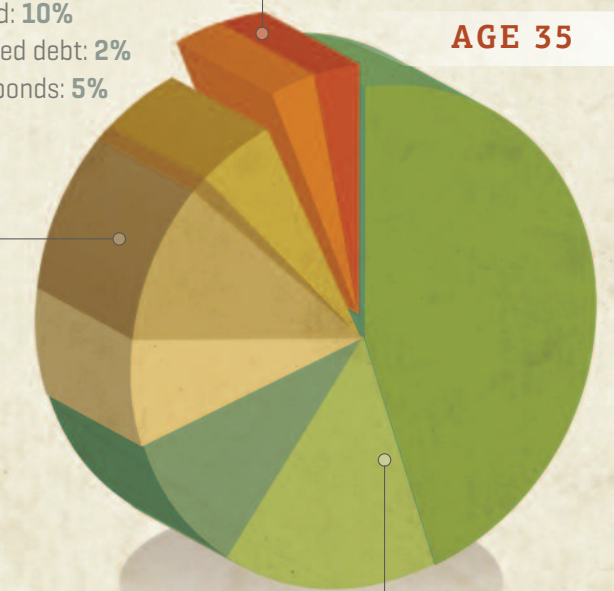
But commodities and real estate should be represented. Real estate is a useful diversifier, and commodities are inflation hedges likely to benefit from the economic growth in emerging countries such as India and China, says Mark Luschini, the Pittsburgh-based chief investment strategist at Janney Montgomery Scott. "As emerging markets build out infrastructure, and the consumer base becomes more prosperous, that generates commodity-related activity," he says.

24%
FIXED INCOME

- > Investment-grade bonds: 7%
- > High yield: 10%
- > Securitized debt: 2%
- > Foreign bonds: 5%

6%
ALTERNATIVES

AGE 35



70%
STOCKS

- > U.S.: 45%
- > Foreign developed: 15%
- > Emerging markets: 10%

55% STOCKS

- > U.S.: 35%
- > Foreign developed: 12%
- > Emerging markets: 8%

25% FIXED INCOME

- > Investment-grade bonds: 8%
- > High yield: 10%
- > Securitized debt: 2%
- > Foreign bonds: 5%

AGE 45

20% ALTERNATIVES

- > Commodities: 3%
- > Real estate: 3%
- > Hedge funds/private equity: 14%

AGE 35

By this age, many investors have accumulated financial obligations—a mortgage, life insurance premiums, children's tuition. The need for liquidity to cover these obligations calls for a portfolio that is still strongly tilted toward stocks, but has a bigger buffer in short-term bonds.

For many, this period also means heightened concern about volatility. There's more at stake—a family's security and a home, for example. Those obligations call for scaling back stock exposure and building out the bond portfolio.

Once savings are maxed out in 401(k)s, IRAs or other tax deferred options, investors using taxable accounts need to keep an eye on taxes and expenses. Investments with

little tax impact that you plan to hold long term should be in taxable accounts. And watch fees: Stay away from pricey actively managed mutual funds and stick to low-cost index funds and ETFs, Ferri says.

AGE 45

Once you hit your 40s, retirement starts feeling less abstract and more imminent. It's a time to hammer out ideas about retirement expectations so you can come up with realistic savings goals. The goals you establish will probably be revised over time, but having an estimated savings target will help you refine your portfolio.

Up to now, the basic approach to risk has been to take on as much as you can tolerate in the name of growth. Now,

with retirement about 20 years away, the question of how much risk you need to take to hit your retirement marks is just as important.

At 40-something, one still has plenty of time to rebound from market downturns, so a big helping of stocks remains logical. But many investors have amassed significant assets and entered their peak earnings years. Some advisors argue that this combination should lead to expanding investments in hedge funds with varying strategies. (Others, like Rick Ferri, would argue that hedge fund returns don't justify their high prices.)

AGE 55

With 10 years to go before retirement, specific goals are a must. The good news is that investors should now be earning the biggest salaries of their careers, and some obligations may have fallen away—kids may have finished college, for example. One of the best moves investors can make now is to amp up savings. And until this point, a healthy exposure to stocks has been a sufficient inflation hedge. But as investors pare back stocks, they should introduce an allocation to Treasury Inflation Protected Securities, or TIPS.

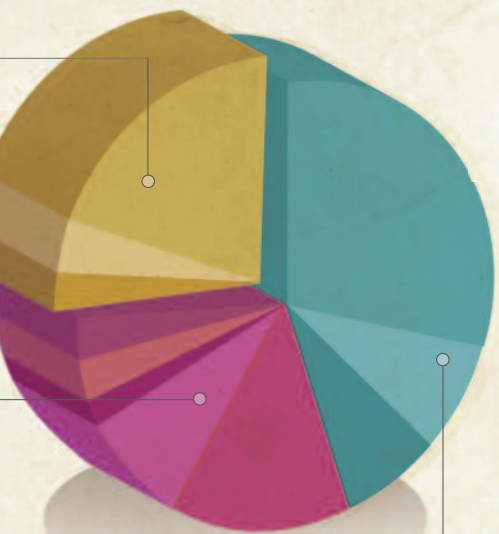
25% ALTERNATIVES

- > Commodities: 3%
- > Real estate: 3%
- > Hedge funds/private equity: 19%

30% FIXED INCOME

- > Investment-grade bonds: 14%
- > High yield: 8%
- > Securitized debt: 2%
- > Foreign bonds: 3%
- > Inflation-linked securities: 3%

AGE 55



45% STOCKS

- > U.S.: 30%
- > Foreign developed: 8%
- > Emerging markets: 7%

45% STOCKS

- > U.S.: 30%
- > Foreign developed: 8%
- > Emerging markets: 7%

AGE 65

10% ALTERNATIVES

- > Commodities: 2%
- > Real estate: 2%
- > Hedge funds/private equity: 6%

45% FIXED INCOME

- > Investment-grade bonds: 35%
- > High-yield: 4%
- > Securitized debt: 1%
- > Foreign bonds: 2%
- > Inflation-linked securities: 3%

RETIREMENT

Just because you've stopped working doesn't mean you stop investing—far from it. With baby boomers likely to live longer than any preceding generation, most folks still need a healthy allocation to stocks to help their assets grow faster than inflation.

Of course, you also need your portfolio to generate income. Not so long ago, a bond portion of the portfolio was constructed to provide all income needs. Today, advisors say depending entirely on bonds for income is unrealistic, requiring too big a fixed income portfolio and sacrificing much-needed growth. A better tactic is to compartmentalize sufficient assets to cover five years in liquid, safe accounts, and position the rest of your portfolio for the best return given your appetite for risk. "The tendency is to want to be ultra conservative," says Deena Katz, associate professor of personal finance at Texas Tech university. "But you have to think how many years you're going to be in retirement. For some people, it's almost as many years as they worked."