

YOUR MUTUAL FUND PORTFOLIO:

CHOOSING THE LEVEL OF COMPLEXITY

By John Markese

Using the three-tiered mutual fund portfolio guideline, you can create any mutual fund portfolio you want that comfortably matches your investor profile in terms of complexity, yet still remain properly diversified.

How simple or intricate you make your mutual fund portfolio comes down to your investor profile: the amount of time and interest you want to spend managing it, your investment knowledge, and the total amount of dollars you'll be investing.

There are, however, some investment constants—no matter what, your portfolio of mutual funds should be:

- Diversified,
- Meet your financial goals, and
- Match your risk tolerance.

Your asset allocation—how much you put into the various asset categories—addresses these financial concerns. What fund types you select and how many funds you invest in to populate the asset categories is driven by your investor profile.

You also need to make sure that, when you think of your mutual fund portfolio, you are considering all of your funds: those held in both your taxable and tax-sheltered accounts, including 401(k) plans, 403(b) plans, IRAs, Keoghs, Roth IRAs, etc. When you view all of your mutual fund holdings as one all-encompassing mutual fund portfolio, it becomes clear that you need not replicate your total mutual fund portfolio allocation in every individual account.

GRADUATED COMPLEXITY

Even with those constants in mind, there are many different “levels” of mutual fund portfolios, ranging from a basic, bare minimum portfolio to one that is very complex.

Three mutual fund portfolio levels are illustrated in Table 1. They are not meant to be discrete portfolios, but rather should be viewed as a continuum, with Level I as a realistic minimum and Level III as a practical limit.

Level I mutual fund holdings can be augmented with Level II fund types and Level II holdings can include Level III fund types. These three levels are milestones on a path from the basic to the complex.

PICKING THE RIGHT LEVEL

What level of complexity matches your investor profile best? Let's walk through the rationale for each level, keeping in mind the effort, knowledge and investment scale issues all investors face.

Level I: The Basics

Level I contains only four mutual funds, but covers substantial investment ground. It is strictly an index fund approach—no actively managed mutual funds are included.

Index funds have the advantages of very low cost and easy diversification, a hard combination to beat. And they are low maintenance investments—you don't have to monitor their performance against the benchmarks, they are the benchmarks. But while you are assured of avoiding underperformance, you

John Markese is president of AAIL.

TABLE 1. MUTUAL FUND PORTFOLIO LEVELS: FROM BASIC TO COMPLEX

Asset	Level I	Level II	Level III
U.S. Stocks	• Total domestic stock index fund	• S&P 500 stock index fund • Extended market stock index fund	• S&P 500 stock index fund • Mid/small-cap growth fund • Mid/small-cap value fund • Sector funds: technology, biotech/health, REIT
Int'l Stocks	• Total international stock index fund	• European stock index fund • Pacific stock index fund • Emerging markets stock index fund	• International stock fund • Emerging markets fund
Bonds	• Interim U.S. govt (or muni) bond index	• Short-term U.S. govt (or muni) bond index • Long-term U.S. govt (or muni) bond index	• Corporate high-yield fund • Long-term U.S. govt (or muni) bond indexes
Short-Term	• Money market fund	• Money market fund	• Money market fund

also have no chance of beating the benchmarks.

Some, but not many, actively managed funds do manage to beat the benchmarks. However, the actively managed funds that may beat the benchmarks in any one period are unlikely to be the ones to beat the benchmarks in the next period. Therefore, selecting and monitoring actively managed funds requires substantially more effort, time and knowledge than an index approach.

Since no fund choice is without trade-offs, here's a closer look at each of the funds in the Level I portfolio.

The total domestic stock index fund is just that: broad-based, with U.S. common stocks of all capitalization sizes—large-, mid- and small-cap. These funds hold about 5,000 stocks, but the key is not just the number, but the weightings. Indexes are capitalization-weighted, meaning that large stocks with high capitalizations (number of common stock shares outstanding times the market price per share) tend to dominate a total stock index fund.

Markets and economies are global in scope and so should be your portfolio. Even if the allocation to foreign stocks is small, they do add to overall diversification and risk

reduction. Economies and stock markets are much more likely to move in concert in the short term, but over the long term, currency exchange rates and economic growth cycles are not perfectly correlated, so some international diversification makes sense.

What is the simplest way to gain international exposure and diversification? An all-in-one total international stock index fund that covers the primary regional economic zones: Europe, Asia/Pacific, and Latin America. With this regional coverage, both developed and emerging international economies are covered, but developed economies dominate the index, as does Europe. Again, within an index, capitalization-weighting determines exposure and diversification.

The third mutual fund component of Level I is an intermediate-term U.S. government bond index or, if the investment is held in a non-tax-sheltered environment and your tax exposure is significant, an intermediate-term municipal bond fund or state-specific municipal bond fund. The index approach to a bond fund is particularly important because of the low expense ratio relative to the lower total return of bond funds in general.

Why an intermediate-term matu-

rity fund, one usually with weighted average maturity of seven to 10 years? An intermediate maturity captures almost all the yield and total return of a long-term bond fund with substantially less fund volatility caused by changing market interest rates.

Why U.S. government bonds? These instruments provide nearly all the return—sometimes more—of corporate bonds, but with no default risk. Also, U.S. government bond index funds are readily available.

The money market fund is included as a place to maintain any necessary liquidity, but may be supplanted by bank accounts or short-term U.S. government bond funds. Any short-term, liquid, fixed-income investment vehicle or combination of vehicles with absolutely no default risk can be substituted for the money market fund, including a municipal, tax-free money fund.

The Level I mutual fund portfolio provides substantial diversification, the lowest costs, and it requires very little time and energy to manage. For those investors with minimum financial sophistication and knowledge, it provides an understandable, efficient portfolio mix. And while its simplicity and index nature can accommodate portfolios of very

modest size, it can also handle the largest without a hitch.

Level II: Add-Ons

Level II ratchets up the complexity of the Level I portfolio for investors that want to be able to control asset allocation and diversification more precisely, but still employ the efficiency of an index approach.

For example, for better diversity but a bit more complexity, Level II breaks the total domestic stock index into two: An S&P 500 index and an extended market index (the other 4,500 stocks), allowing choice in asset allocations between large-cap stocks and mid- and small-cap stocks, improving diversification possibilities.

Similarly, the foreign markets are broken down into a European stock index, Pacific stock index fund and an emerging markets stock index fund. This allows choice in allocation between the more developed markets and the emerging markets of the Pacific Rim and Eastern Europe.

For the bond holdings, Level II offers a short-term U.S. government bond index and a long-term U.S. government bond index, enabling you to create your own maturity level. A long-term U.S. government bond index can provide a higher return, although with more volatility; combining it with a more stable, although lower-yielding short-term government bond fund allows you to control how much extra risk you are willing to take on for added yield.

Level II should be thought of as an opportunity to mix and match with Level I, rather than as an either/or choice. For example, you may want to break the total domestic stock index into Level II segments, but

keep the total international stock index as in Level I. Similarly, you may want to stay at Level I for your bond holdings while shifting to Level II for your stock holdings.

Level III: Active Components

In the Level III fund portfolio, actively managed funds rather than index funds dominate, but again, substitutions from Level I and II can be made.

The rationale for the complexity of Level III is increased control over asset allocation and actively managed funds in sectors that are less efficient—i.e., market segments where fund portfolio managers have the best chances of adding return to more than cover the increased cost of active management over indexing. Large-cap domestic funds (the S&P 500 index fund), and government bonds (the U.S. government bond index fund) remain indexes because of the information quality and efficiency of pricing in these areas.

The S&P 500 index fund includes large-cap value stocks and large-cap growth stocks. In the mid/small-cap area, two actively managed funds—one value oriented, one growth oriented—are included because these funds generally encompass different industries and sectors, requiring different knowledge and talent on the part of the fund's portfolio managers.

Sector funds with the most funds available and of most interest to investors are listed as the extreme of concentrated, much less diversified, expensive and actively managed funds. Investment in these sector funds mandates considerable effort in selection, monitoring, and knowledge.

Similarly, the corporate high-yield fund generates substantial income but presents challenges and risks

during certain business and market environments.

Other than the two index funds, the Level III fund portfolio is a high-maintenance, high-financial-sophistication fund portfolio, requiring significant selection and monitoring effort to earn the chance for above-index-fund returns. Level III can handle significant wealth, but would be impractical for very modest investment sums due to the number of funds and the minimums often required for investment.

If actively managed, large-cap growth and value funds are substituted for the S&P 500 index fund and a general bond fund that actively invests among bond issues and bond market segments—such as corporate, mortgage-backed, and government agencies seeking total return, income, and capital gains—is substituted for the U.S. bond index fund, the complexity probably reaches the maximum any investor can reasonably expect to handle well.

CREATING YOUR OWN LEVEL

Using these portfolios as a guideline, you can create any level you want that comfortably matches your investor profile, yet still remain properly diversified.

Substituting index funds from Level I helps keep the complexity down, while substituting Level III actively managed funds, such as the sector funds or corporate high-yield bond funds, ratchets the complexity up.

Just don't forget the trade-offs, and remember that Level I is near minimum but still effective, while Level III is near the maximum limit and only holds promise of increased return and lower risk based on your efforts and skill. ♦