DOW THEORY FORECASTS®

Managing your portfolio

Successful investing is a two-part process:

◆ Selecting the best investments.
◆ Assembling and managing those investments in a portfolio.

While the *Forecasts* tends to concentrate on the first part of this process — stock and fund selection — the second part is no less important. Admittedly, making specific portfolio-management recommendations is tough to do in a newsletter, as proper management depends to a large extent on an individual's own characteristics — age, investment time horizon, risk tolerance, financial responsibilities, etc. — and the *Forecasts* cannot know these things about you.

Nevertheless, we can address some best practices of portfolio management relevant for every investor. Consider the following four issues when managing portfolios:

1. **Allocation:** How your portfolio is divided across asset classes — stocks versus bonds versus cash versus real estate etc. — will likely have a bigger impact on variability of returns than individual security selection.

   There's no precise answer for the perfect allocation. One rule of thumb is to subtract your age from 110 and invest that portion of your "family" portfolio in equities. Based on this rule, a 60 year-old should have 50% of his assets in stocks. Unfortunately, this benchmark assumes all 60-year-olds are the same — identical risk aversion, financial responsibilities, cash-flow requirements, etc. While we find the 110 concept useful as a starting point, consider it a guideline rather than a hard-and-fast rule.

   Given what could be rather subdued bond returns going forward, investors may want to carry a bit more equity in their portfolios going forward. Thus, a 60-year-old reasonably comfortable with risk may want to consider an equity allocation of 60% or even 70%.

   The 110 rule can help you calibrate the level of risk you assume. For example, a 75-year-old who remains 100% invested in stocks is taking a very aggressive position. That approach may make perfect sense when you understand the investor's position. For example, perhaps she has plenty of cash flow from a pension and real estate investments and wants to grow the stock portfolio for the benefit of her heirs. Such an investor can afford more equity exposure than one who needs her portfolio to fund living expenses.

Bottom line: Be aware of your asset allocation and avoid outlier positions (way too much or too little stock relative to your age and risk aversion). Make sure you include all of your family assets — investments held by a spouse, real estate, etc. — so you have an accurate picture of your allocation.

2. **Diversification:** You can diversify in three primary ways:

   - *Across assets* — stocks versus bonds versus cash versus real estate versus commodities.
   - *Within asset classes* — domestic stocks versus foreign stocks, small caps versus large-caps, corporate bonds versus Treasurys, short-term bonds versus long-term bonds.
   - *Across time* — investing in a gradual fashion, such as dollar-cost averaging.

   When it comes to diversification, don't think so much about a magic number for exposure. Rather, examine your market coverage. If your market exposure is narrow and heavily concentrated in a few sectors and style boxes, use funds and ETFs to fill in the gaps, especially for international equities and bonds. Consider diversification across all of your family assets, not just a single portfolio.

3. **Placement:** Where you hold investments is an often-overlooked piece of portfolio management. Let's say you have taxable and non-taxable accounts. You may wish to place bond investments in traditional IRAs to avoid paying annual taxes on the cash flow. In contrast, long-term equity investments make more sense for taxable accounts, where you can defer taxes indefinitely and should pay lower tax rates on gains when realized.

   Also, you can use equity losses in taxable accounts to offset gains; you cannot so do in nontaxable accounts, such as IRAs. Finally, you may want to place high-growth-potential investments in a Roth IRA, where you can shield the expected gains from tax implications.

4. **Rebalancing:** Portfolio allocations should change over time, depending on the performance of the various portfolio components. It is important to monitor these changes and make adjustments to ensure your portfolio doesn't stray too far from your optimal allocation. Rebalancing, or restoring asset weightings to desired levels, is an important part of portfolio management. However, rebalancing a portfolio generates trading commissions and potential tax liabilities in taxable accounts.

   Consider these two approaches when rebalancing a portfolio. If you wish to rebalance a nontaxable portfolio and your trading costs are minimal, rebalance annually. If you wish to rebalance a taxable account, don't make adjustments until the shifts in your allocations exceed 5% of your optimal asset allocations.