**Asset Allocation Report Tutorial**

**Real World Personal Finance Software**

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**Overview of Our Investment Management Process**

This text is to help you understand the overall concepts, and technical details, of the reports that follow. It starts with basic concepts of how we manage your money.

The first and most important step in the financial planning and investment management process is Discovery. This is where our questionnaires asked you various multiple-choice, fill-in-the-blank, and essay questions. It’s also called Fact Finding or data collection.

Your answers help us determine your investment risk temperament and tolerance, goals, time frames, cash flows in and out of the portfolio, and what you have to work with. It's also where you'll put into writing what it is you want us to do for you. This data helps us formulate investment policy that best fits your needs and objectives. This is then formally summarized in the Investment Policy Statement that follows.

Once these two preparatory phases are completed (Discovery & IPS creation), we can start to manage your assets, and use financial planning software to help forecast your future.

Forecasting your future (cash flow projections, net worth projections, life insurance needs, retirement planning, and college funding) is a different topic, and is discussed in detail in other parts of your financial plan.

**About the Three Ways to Manage Money**

The third phase of investment management is deciding how to manage your investments. Since there are only three ways to go, it’s critical to first understand the advantages and disadvantages of each. The only three ways money can be managed are:

1) Market Timing: Whenever one makes an investment decision based on a forecast of a market, asset class, or security going up or down, then market timing is being utilized.

2) Security Selection: This is deciding which security to buy or sell compared to others of the same type. For example, deciding whether to buy a bond or a growth stock would be an asset allocation or market timing decision. Deciding whether to buy AMD or Intel would be a security selection decision. This is because both stocks are in the same asset class. Stock and ETF picking are the most common forms of security selection.

3) Asset Allocation: This is the art and science of how money gets divided up between different asset classes to lower risk and increase returns. This is also known as optimizing an investment portfolio, making it more efficient.

Asset allocation is just investment jargon that means how the money in your portfolio gets divided up between the different asset classes. An asset class distinguishes one type of investment from another. Asset classes are how different types of investments are categorized to distinguish them from one another. For example, CDs, bonds, stocks, gold, and real estate are different in terms of risk, reward, taxation, and income generation.

Most investments can be categorized into one of four major asset classes: stocks, bonds, tangibles (things you can touch), and cash. There are dozens of asset classes in the U.S., and most also have a mirror-image in the overseas markets. We may use up to a couple dozen, depending on various circumstances.

Every investment decision uses either one, or a combination, of these three methods. Also, all three methods can be used simultaneously in making one investment decision.

Out of the three ways to make investment decisions, we focus on mainly one - asset allocation. Now for a little more on the other two methods, and why we don’t use them.

**Security Selection (stock and/or ETF picking)**

Security selection is deciding which investment to purchase, or sell, compared to others of the same type (or within the same asset class).

We practice a little bit of security selection by using Morningstar database software to screen mutual funds (and things like ETFs and variable annuity subaccounts when needed). This is the initial phase of the screening process because we feel mutual funds that are highly ranked in their category over several time frames, peer group, and asset class tend to remain highly-ranked long enough to be useful.

We look for mutual funds that rank in the top 20% (this number varies for each asset class) in various time frames. If a fund ranks in the top quartile of their peer group in most of these time frames, then it is a candidate for further screening, which may include calling the fund manager. We perform this screening for all of the asset classes we use except for cash (money market).

We’re looking mostly at total return numbers at this phase. We don’t care much about the risk of each asset class at the individual fund level because these risks are mostly diversified away during the asset allocation process. In fact, for some asset classes, we want to see funds that are the most risky (highest Beta numbers) in their asset class.

Small-cap funds, for example, should have very high Betas – the higher the better. When the markets go up – this asset class should roar ahead much more than the S&P 500. When the S&P 500 goes down, we expect this asset class to go down much more than the S&P 500 too. If the mutual fund behaves in the future like it did in the past, then the gains in the good times usually will more than make up for the losses in the bad times.

When it comes to individual stock picking, most empirical studies have shown that similar common screening practices add little value. This is because:

- There are just too many stocks

- There is too little information publicly available

- All publicly available information is quickly outdated

- There is never enough time or resources to do a thorough analysis

- Things change significantly on a daily basis

- Everyone else is using essentially the same software tools, strategies, and methodologies

- The critical information needed to forecast where the stock may be headed over any time frame is just not available to the public.

The only people with the pertinent information needed to forecast the critical variables on where a stock may be headed (earnings, growth rates, etc.) are “insiders.” Some examples of insiders are the corporate executives, other key employees, their investment bankers, lawyers, accountants, etc. These insiders are prohibited by law, and from corporate policy, from disseminating this information to the public. Most are not even allowed to trade on this information themselves.

The bottom line is that the only people that actually know how the company is doing on a daily basis, and therefore where the stock is going, are people who are not allowed to do anything about it (by trading the stock), nor tell anyone.

Because of these problems, the bottom line is that the vast majority of stock pickers lag the market (or their proper benchmark index) over time. In light of this, other than screening mutual funds that hold dozens of stocks, we believe the practice of security selection is not appropriate for most of our clients.

We leave stock picking and market timing up to the mutual fund managers, because they have the resources to specialize in picking stocks of a single asset class. We feel this is the only way to get decent results for individual investors.

**Market Timing**

Market timing is seeing where a market or security currently is, and then betting where it may be going, and when. Any time an investment decision has a time frame associated with it (this will do this by this time), market timing is being used.

If you like your adrenaline pumping all the time over investments, and realizing returns that are less than the S&P 500, then market timing and stock picking is for you. You don't hear about asset allocation in the media because it's just too boring!

The biggest reason people do this is because it's fun to play on Wall Street. Some just need their jobs to be exciting more than they need to make a stable income and realize good returns with acceptable risks for their clients. It's an exhilarating ego-boost to make a lot of money being correct on a stock bet. You feel like you've just won a sophisticated high-tech battle in an intellectual war with people that thought they were smarter and better than you. To these warriors, using mutual funds is not only too boring; it's just resigning to join the herds of plodding commoners. It's also fun to gamble in Vegas, but you know how that usually ends up. These days, most of these folks have realized this, and have given up on trading stocks, and have moved to trading exchange traded funds (ETFs). This strategy "doesn't work" either, but at least it’s less risky than stock picking.

The tortoise and hare analogy fits well here - where the tortoise (asset allocation) is slow and boring, but eventually wins over the exciting fits and starts of the hare (market timing and/or stock / ETF picking).

Why can't making low-risk money be fun and exciting? In order to make exciting money using market timing or stock picking techniques, you'd need to show a net profit on four investment decisions: You need to sell something (#1 - what to sell out of assets currently held) at the right time (#2), to generate the money needed to make new purchases (#3 - what to buy) at the right time (#4).

To win at the market timing game, one needs to be correct more than 60% of the time to cover the losses caused by mistakes of the other 40%. It’s not close to 50 - 50 because of the trading commissions, capital gains taxes, and other transaction costs associated with trading securities frequently.

Usually a "mistake" is made on one of these four decisions, and those losses negate gains on the correct decision(s). Mistake is in quotes because market timers rarely acknowledge their mistakes. They always have a long-winded explanation about unforeseen events, it wasn't their fault, and how they would have been right, if only it wasn’t for this or that and the other. The bottom line here, is that every time they're "wrong," it is their "mistake" – on multiple levels.

Then on top of that, you'll have to subtract out all of their fees, trading costs, administrative costs, and taxes. If that weren't true, then someone would have figured out how to make market timing or stock picking work, and they would have their own daily TV show. At any given time, there is at least one "tard" with their own TV show, but if they actually maintained an investment track record, it would be unbelievably dismal (which is why they don’t have one). Regardless of their record, there has to be at least one of these shows on at all times, just because there's enough "Joe-six-pack armchair investors" that will watch it, and that's all it takes for the sellers of commercials to fund it (regardless of how much it harms the investing public).

Investment markets are just the sum of millions of people reacting to random daily news by trading securities. Because nobody can predict the news, nobody can predict the future no matter what computer models they use. That's why you'll never see the same investment guru on TV for more than a few years. It's usually the one that got lucky recently. When their luck runs out, they're replaced.

This is also why media gurus are usually mutual fund managers (and are CFA Charterholders). Only large institutions like these have the resources needed to have any chance at profiting on all four trades simultaneously, and have the economies of scale to keep expenses down (plus they don’t have to care about the taxes you pay).

Everyone else is just misleading by hype, and is making you lose money. This is because these gurus are selling the same securities right after making their public recommendations to buy them. This is known as the "greater fool theory."

They're basically telling you when to buy, but not when to sell. First the guru buys a ton of a stock or ETF to make it go up a lot. Then to get on TV, they make something up about how its fundamentals or charts (all meaningless technical analysis babble) indicate it's going to go up much more. Then they convince fools to buy it via TV. Then it will go up just because these fools are buying it, allowing the guru to sell it all at much higher prices. This drives the price lower. Then all of the fools that bought it from the guru are then left "holding the bag with the bill of good inside," while the guru locked in large profits. This makes the guru's performance look spectacular, which gets them invited back to the show. This scam is perfectly legal and still happens daily!

So if you're susceptible to taking a market guru's advice because you agree with what they're saying, and it i's working great at the moment, then just wait. Most of the time, it will be around a year before their luck runs out, they've lost a lot of money, and have disappeared from the media. The point is you don't know when their lucky streak will expire.

Try to remember who the big TV financial gurus were a decade or a few years ago. How long has it been since they've been on TV? How many were either booted out of the business or went to jail for insider trading or similar infractions? How did their stock tips pan out a year after they recommended them? How many just disappeared because their dismal track record was publicized? They don’t retire and go away because all of sudden they’re rich enough. Their egos are much too big for that. They went away because their fans quit giving them the big easy money, or a new Bieber or Kardashian came along that gets better ratings.

They also tout stocks that their firms' have investment banking relationships with (the investment firm that brought the company's stocks and bonds to the marketplace) so they can sell their inventory to the public easier. This is where most of the money is made on Wall Street. If this doesn't sound right to you, you're right - it's not, and there are a lot of things wrong with the financial markets that will never be fixed because of big money.

Here's what to do about these situations: Write down the name of the guru, the security they recommended, and what their forecast was in terms of price movement over a certain time frame. Then write on your calendar when to review this call. When that day comes, compare what actually happened with their original call. Then you'll see that 90% of the time, they're just wrong. That should be enough to get you to just change the channel.

**Using Asset Allocation Strategies Helps and Saves You in Many Ways**

• An old Wall Street adage is you have to assume more risk to realize more return. But you don't always realize more return just by assuming more risk in the real world. Most of the time, when you assume more risk, you just lose more money. Asset allocation allows more control over how much return you'll probably get in exchange for assuming more risk.

• Asset allocation is the only non-derivative technique you can use to reduce risk (lower overall portfolio volatility), increase income, and get better returns, all at the same time. It's the only one of the three ways of managing money actually that reduces risk. The other two methods of investing only greatly increase risks.

For example, if the S&P 500 goes down 20%, your diversified investment portfolio of 1,000+ stocks and bonds of all types will probably be down less than 15%. This is because you'd have less exposure to those 500 stocks when you hold other asset classes. If you're a stock / ETF picker or a market timer, then chances are you'll be down over 25%. This is somewhat because pickers and timers mostly use stocks or ETFs in the S&P 500.

• Even though using asset allocation eliminates the need for you to time markets and pick securities, it still has to be done by someone. That's the mutual fund manager's job. They have the armies of analysts and millions invested in computers, people, and systems needed to perform these mostly futile tasks. You don't, and that's the point. If you want to compete with them, then you'll lose most of the time. Winning means realizing low risk and good returns, while not having to waste time and money trying to manage money.

• Asset allocation saves you a lot of time. Other than updating mutual funds and quarterly rebalancing, you don't have to pay much attention to investment portfolios. If you really want to minimize time, you can use index mutual funds or index ETFs, which rarely need to be monitored or updated (but still need to be rebalanced).

• Asset allocation saves you grief, worry, anxiety, stress, from losing sleep, and having to be glued to the TV or phone or computer to keep track of the markets and your holdings. There's no need to baby-sit a security, and have constant access to a phone or the Internet, to be ready to trade at all times to avoid losses. Asset allocation allows you to sleep well, take real vacations, and to turn it all off.

• Asset allocation saves you money because you don't have to pay top-dollar for all of the trading costs associated with high-turnover market timing and/or stock or ETF picking strategies. It's the mutual fund managers' job to do all of the trading. You'll still have to pay these mutual fund management fees, but they're much less than you'd pay on your own. They're able to keep their expenses down because of competition and economies of scale.

• You can still brag at parties that you were smart enough to buy something before it took off. When you hold a diverse portfolio of mutual funds comprised of many asset classes, you're bound to be holding securities of the current fad. Whatever the current hot thing is you'll most always be able to say, "I bought that before it went through the roof!"

• Asset allocation strategies are also great for diversifying and enhancing portfolio income, which is critical during retirement. Maximizing investment portfolio income greatly reduces the need to dip into principal (sell shares). Investment portfolios will last much longer if you can get the spendable income needed to pay living expenses mostly by their normal income distributions (interest, dividends, and realized capital gains).

• Asset allocation also saves advisors from getting into trading trouble. First, stocks are the #1 source of trading trouble. Trading ETFs are #2. Then there are no B or C-share classes in our mutual fund recommendations, so those compliance red flags will never be raised. There are also many times fewer trades when you buy and hold mutual funds compared to trading stocks / ETFs or timing markets. So compliance won't annoy you about excess trading (AKA churning) just to drum up more commissions.

Then as anyone with trading experience knows, there’s always mistakes made, and money is lost when they can’t be fixed. Asset allocation minimizes trading and its mistakes as much as possible. Fewer trades result in lower trading costs, less administrative work, fewer mistakes that need to be fixed, and less risks.

**The Disadvantages of Asset Allocation**

You're probably going to pay a little more in taxes with asset allocation, because you're probably going to be making more income and profits. You'll also probably be realizing less tax-deductible losses.

You also won't be the life of the party when the topic is stock trading or market timing. Why? For the same reason the media only focuses on market timers and stock pickers. Because asset allocation is much too boring! There's literally nothing to talk about other than which asset class is currently up or down, and why.

You're also guaranteed not to strike it rich if a big bet pays off. If something doubles overnight, only that portion of the portfolio that was invested in that asset class will be affected. This is usually less than 10% with asset allocation. If it’s a stock, then it could be less than 1% of your total portfolio’s holdings.

Gambling with a large portion of money (using stocks, ETFs, margin, derivatives, etc.), and lucking out, is the one and only way to get rich quick in financial markets. Very few advisers can do this in efficient markets these days. You've been at it for years, and haven't struck it rich yet. It just gets harder every day, so why keep trying?

Because we feel two of these three major determinants of portfolio performance (security selection and market timing) are not appropriate for most investors, we focus mostly on asset allocation. We feel a finely tuned methodical asset allocation process has, by far, the most impact on determining whether or not your portfolio will help you reach your long-term financial goals.

The most famous and comprehensive asset allocation study was done by Gary P. Brinson, Brian D. Singer, and Gilbert L. Beebower in 1991. Most other findings drew the same conclusions. The bottom line is that considering everything (commissions and other transaction costs, taxes, and mistakes), over 91% of long-term portfolio performance is derived from the decisions made regarding asset allocation.

Results reflect this infamous study.\* It concludes that 91.5% of investment performance returns stem from the asset allocation decision, and not the security selection or market timing decisions. In English - The behavior of asset classes, and their interactions with each other, are much more important factor than choosing the best-performing securities to represent them, or when to trade them.

In other words, it doesn't matter too much that the actual investments selected outperform their proper benchmark indices. What matters most is utilizing optimized and efficient asset allocation strategies, and then consistently picking investments that are a close proxy to their asset classes (or just using index funds).

Gary Brinson, Brian Singer, & Gilbert Beebower “Determinants of Portfolio Performance: An Update,” Financial Analysts Journal, June ‘91

**How Asset Allocation Works**

Different correlation coefficients between investments are why asset allocation works much better for individual investors than anything else humanity has ever invented.

When investments move up and down perfectly in sync with each other over a certain time frame, its correlation coefficient is 1. When assets move in the opposite direction with each other, its correlation coefficient is -1. Both of these scenarios never happen. The average is around 0.7.

All it takes is for it not to be over 0.9 to add diversification value to a portfolio. This is the core of MPT (Modern Portfolio Theory), which started in the 1950s.

The point is to hold a balanced mix of asset classes that have both good returns on their own, and go up and down at different times relative to the other investments in the portfolio. Determining which assets classes to hold is an art, a science, and depends on the circumstances and goals of the investor.

Holding an investment portfolio comprised of asset classes with healthy correlations to each other is just about the only free and reliable method to reduce the primary risk of losing too much money if and when the markets go down, while still getting both the returns and income that will be acceptable - all while giving you any chance at all of outperforming the markets.

This is because whenever you check the portfolio's value, there's usually always something that's doing so well, that it keeps the portfolio as a whole from having negative returns, even when the U.S. stock markets are down.

Asset allocation can be looked at as an enormous board game with about 25 buckets that hold money (each bucket could contain several sub-buckets too). There are trillions of dollars in all of the financial markets, and all of this money is spread between these buckets (around 20 trillion just in U.S. stocks alone at the time of this writing). The buckets all stay on the board at all times, and around one trillion dollars gets shuffled between buckets on a normal day.

For example, if tech stocks go down 10% in a day, it's because more people sold, and wanted to sell, tech stocks than wanted to buy them that day. These sellers got money when they sold, and if they didn't buy any other kinds of investments, this money just went into the cash (money market) bucket. Few like getting low-single-digit cash returns, so over the next day or so, this money finds its way into the other buckets. Which buckets they go into are mostly determined by the security selection and market timing decisions of short-term traders.

One of the main points of asset allocation is to have exposure to a little bit of just about every major bucket that this cash is likely to go into. This way no matter where the money goes, you're already there. This eliminates the need for market timing, because you're in most every major market all of the time.

For example, if ten billion worth of tech stocks were sold net in a day, then this ten billion dollars has to go somewhere - cash, bonds, real estate, large-cap value stocks, etc. If you consistently own a little bit of everything, then it's hard to lose a lot of money long-term because it all has to stay on the table in one bucket or another. It's just a question of which bucket it will be shuffled to next, and when. Since nobody knows which, it’s best to just have a little bit spread around between most all of them all the time.

It happens every dozen years or so, but it's rare for all (major) asset classes (buckets) to be down at the same time for very long. So when a well-allocated investment portfolio is down, it doesn't stay down for very long. This is because if a lot of markets are down at the same time, it means everyone is hiding in cash / money markets. People don't like getting 0.5% to 2%, so they're just waiting to pounce and put this money to work somewhere as soon as they stop being "frozen up like a deer caught in headlights by uncertainty." When this happens, there is usually a big sudden rally in at least one major asset class. That's why the best time to invest is when everything is down at the same time because everyone is "uncertain."

By playing the investing game this way, instead of guessing which bucket will do best short-term, you'll not only eliminate the risk of not being in the right bucket at the right time, but you also don't have to guess where the right bucket will be in the future. If you try to predict where the big money will move to next, then more than likely the bucket you took the money from will be the next place it will go, and the big money is just waiting to leave the bucket you picked.

If you paid capital gains taxes on the sale, you'd would lose on four fronts (taxes, trading costs, and being wrong with your market timing bet twice).

Since nobody knows when, and by how much, money will move to next bucket, it's just best not to guess.

We feel just having a balanced mix between most all of the buckets, all of the time, is the best way to minimize investment risk, and still get good returns. Just be in as many viable asset classes as you can all of the time, and you can always tell people you were there for the big rally at dinner parties, while the stock pickers and the market timers missed the boat.

The different asset classes can be looked at as ingredients that go into making a pie. Each one individually tastes pretty bad. But when they’re all put together in the right combinations, the result is a pie that tastes just right.

**Summarizing the Basic Concepts of the Investment Reports**

Initially we asked you many questions to get to know you and your investment risk tolerance better. Once we know you, then we know how to invest your money.

Then we determine how much of various types of investments (asset classes) you should own. This is called the “Guideline Allocation.”

Then we analyze how much of which types of investments you currently own. This is called your “Current portfolio(s).”

We then are able to recommend a new portfolio based on the difference between what you should have, compared to what you now have. This is called your “Proposed portfolio(s).”

Some investments you own we’re recommending that you sell. Some may be fine, so we think you should keep some, or all, of them.

There are various reasons for this. The most important is that the investment first be analyzed to see which asset class it is in. Then it can be compared to benchmarks of the same asset class to see if it’s performing well or not. It not, then it should be replaced by a similar investment that is.

The next most important thing is that an investment be pure to only one asset class. Investments that contain too many different asset classes rarely perform well, so they should be discarded. This is because the mutual fund managers are shuffling money between the different types of investments at random on a daily basis. This should only be done by someone that knows you and how much of each type you need. They don’t know any of their investors, and so they’re just trying to time the markets to get better returns.

This seldom works well, so they should all be avoided. Here are some examples of mutual funds (and ETFs) with the following word in their names, or objectives, that tip you off to using this sub-optimal strategy: World, global, asset allocation, target, retirement with a future year after it, lifestyle, life cycle, hybrid, or balanced.

The main overall goal is to get the kind of portfolio performance that fits your life, while minimizing the risks. Because we use several different kinds of mutual funds, each holding around 50 securities, the risk of losing a lot of money because one stock crashed is minimal.

**Explanation of the Asset Allocation Report**

The first colored page in the report (titled Asset Allocation Calculator) shows how we determined your guideline asset allocation mix. This guideline mix of asset classes is the recommended amounts of different types of investments we’re shooting for. This is not an exact science, so this money management tool just gets us in the ballpark, by using your personal circumstances as a guide.

Your personal particulars are weighted in five sections according to their importance. The section called Risk Category is the most important, and so it's weighted the heaviest.

Your answers to the multiple choice questions of our Investment Discovery Questionnaire were scored, weighted according to their importance, totaled, and the end result put you into one of the five most-commonly used investment risk tolerance categories.

This goes by different names depending on whom you talk with, but the concept is the same: Investor risk tolerance, risk temperament, risk profile, investment profile, investor profile, investment profiler, investor profiler, investing risk tolerance, risk category, etc. Don’t get confused, because it’s all the same thing.

Unless both spouses’ portfolios are being managed separately, an average of both of your risk tolerances was used in the calculations.

Because none of this is an exact science, most investment managers work with three to seven risk categories. We use five because we feel three isn't enough and seven is too many. These five categories are summaries of how the investor feels about investment risk, how much downside market fluctuations can be tolerated, and how much they expect to profit when the markets are going up

**The Five Investment Risk Tolerance Categories in Detail**

Conservative: This investor isn’t willing to tolerate "noticeable downside market fluctuations," and is willing to forego most all significant upside potential, relative to the markets, to achieve this goal. In English, they really really don't want to get their monthly statement and see less money than they had before (unless it was due to their withdrawals).

Most conservative investors want their portfolios to provide them with an inflation-adjusted income stream to pay their living expenses. They're either currently depending on their investments to give them a retirement paycheck, or are expecting this to happen soon. Some are on tight budgets and are barely making a living as it is, so they are very afraid of losing what little money they have left. They do not have time to recoup any losses (because they can't go back to work for a multitude of reasons). Some realize they don't need their portfolio to provide income for more than several years, because of low life expectancy, so growth is not the objective.

The majority of their money should be held in cash and high-quality short- and intermediate-term maturity bonds. Very risky asset classes are typically avoided altogether.

Satisfying their needs is hard to achieve when inflation is high, or rising, because the market value of fixed income securities (bonds) typically are declining due to increasing interest rates. So investing defensively is not without risk. There is no way to eliminate all risks when investing.

So the investments most desired by Conservative investors are the ones that lose the most value from inflation (e.g., fixed annuities). Investing defensively is not without risk, and there is no free lunch, nor a magic investment to solve one's problems, for anyone in investing (but our Conservative High-income Model is the closest thing invented to being the “magic solution” to this dilemma).

In this case, the potential for the large loss of nominal dollars (how many dollars one has relative to how many they started with) is low, but the loss of real dollars (the inflation-adjusted worth of those dollars) is guaranteed. This is caused by the loss of purchasing power due to the prices of everything in their family budget going up.

Cash (savings accounts, money market funds, and CDs) most always lose real value over time because of the combined effect of taxes and inflation. There isn't much one can do if this happens, except to have exposure beforehand to asset classes that benefit when inflation increases (real estate and tangible / commodity-based mutual funds, like the precious metals and energy sectors). The catch is most of these are the same asset classes that are usually minimized, because they're "too risky," and/or don't provide a reasonable income yield.

Because Conservative investors are still "investing," they should have a higher return over most rolling three-year periods than investing 100% in money market funds, fixed annuities, CDs, and other bank instruments.

The typical range of annual returns in down financial markets are -4% to 0%, in flat markets 1% to 4%, and in up markets 5% to 7%.

Conservative portfolios produce the highest annual income yields - typically in the range of 4% to 6%.

Conservative portfolios produce very little capital gains distributions.

If an investor is so risk adverse that they cannot tolerate ANY downside risk to the nominal value of their money, then we recommend money market funds, or just putting their money in the FDIC insured bank.

We don't use an investor risk tolerance category for these ultra-conservative investors because we don't think these folks are investors in the first place. They have resigned to the fact that their real returns will be negative after considering taxes and inflation, and just care about not seeing the number of dollars they have decline. They should just hide it all in the safest vehicles possible. But not "under the mattress" because of its purchasing power will be substantially eroded from being 100% exposed to inflation.

Moderately Conservative: If a worried investor can tolerate a little more risk than the Conservative investor, but still is adverse to large short-term downside fluctuations, and wants a little more return with a little less income, then this is the category for them.

The typical investor in this category is either retired and getting their paycheck from portfolio income, soon to be retired, or has been burned by poor investment management and has lost money in the past. These folks want to be protected somewhat from large downside market fluctuations and are willing to not fully-participate when markets rally upwards to get it.

Informed investors realize that if their life expectancy is more than a decade, then having exposure to investments that increase in value is needed to provide adequate income in the later years. These folks want to be protected somewhat from large downside market fluctuations and are willing to not fully participate when markets rally upwards to get it.

Their portfolio will still fall when the markets' decline, but they want to be somewhat protected from sudden double-digit percentage declines in their portfolios. They want to be in the game, but they are definitely playing defense. They also want to see low double-digit percentage gains when the financial markets are going up. This is achieved by having a significant exposure to fixed income securities, several different types of stocks, real estate, and tangible commodities that somewhat track inflation. Core equity asset classes are used, but very risky asset classes are still held to a minimum.

Moderately Conservative portfolios produce significant annual income yields - typically in the range of 3% to 5%.

Moderately Conservative portfolios produce little capital gains distributions.

They are typically going to achieve returns a little more than taxes and inflation. When the major markets are increasing, they could realize double-digit returns. The typical range of annual returns in down financial markets are -7% to -1%, in flat markets 0% to 5%, and in up markets 6% to 9%.

Moderate: The majority of investors are in this middle-of-the-road category. The reasons for people to be in this category are too many to list here. The most-common is the desire to invest long-term for retirement or college funding. The current need for portfolio-generated income is usually several years away.

These investors want good returns, and know they're taking some risk to get them. They should expect returns similar to a basket of similarly weighted market indices. Their portfolio should go up less than the markets as a whole, but should also go down less when markets go down.

A Moderate portfolio will hold a balanced mix of most all-major viable asset classes (for maximum diversification), which will include conservatively-managed bond funds as well as high-risk stock funds. This category typically uses the largest number of asset classes to both reduce risk and increase profits. Both safe and risky asset classes are utilized pragmatically. Balance between profits and loss reduction is the goal.

They know they will lose money if the markets go down, but also expect to be along for the ride if they go up.

Moderate portfolios produce modest annual income yields - typically in the range of 2% to 3%.

Moderate portfolios produce a moderate amount of capital gains distributions.

Moderate investment portfolios are usually compared to the S&P 500 to see how well they're doing. When the S&P 500 is going up, it should be up a little more than a Moderate investment portfolio (if it's very well managed). When the S&P 500 is down, the Moderate portfolio should be down less.

They are typically going to achieve returns greater than taxes and inflation. When the major markets are increasing, they could easily realize double-digit returns. The typical range of annual returns in down financial markets are -8% to -2%, in flat markets -1% to 4%, and in up markets 5% to 10%.

Moderately Aggressive: If an investor wants to outperform a basket of similarly weighted indices when the markets are up, and doesn’t mind too much being down a little more than the markets when they are down, then this is the category for them.

They are taking on more downside risk than the markets, but expect to be substantially ahead of the game when markets go up. Fixed income positions are minimized and risky asset classes are fully utilized. Most of the bond and international stock mutual funds in this portfolio are aggressively-managed.

These investors want to take the risks of winning the game by playing hard offense, but still don’t want to lose too much in a short period of time. Most Moderately Aggressive investors want to accumulate a significant amount of wealth in the future, are willing to wait a significant amount of time for the rewards (and to recoup short-term losses), and have earned-income to contribute to the portfolio over time.

They know they will lose a high percentage of their money if the markets go down (more than the S&P 500), but also expect to profit greatly if they go up. More emphasis is put on making money than preventing the loss of money.

Moderately Aggressive portfolios produce the little annual income yields - typically in the range of 0.5% to 2%.

Moderately Aggressive portfolios produce a high amount of capital gains distributions.

They're typically going to achieve long-term returns far greater than taxes and inflation. When the major stock markets are increasing, they expect to realize double-digit returns. The typical range of annual returns in down financial markets are -10% to 4%, in flat markets -3% to 6%, and in up markets 7% to 11%.

Aggressive: Damn the torpedoes, full speed ahead! These investors want to substantially outperform the markets and (should) know they are exposed to much more risk than the markets. They could easily lose up to 40% of their portfolio value in a few months, and it may take years, if ever, to recoup these losses.

These investors typically hold mostly growth, small-cap, and sector mutual funds (or stocks or ETFs). Any fixed-income mutual funds in the portfolio are a small percentage of the portfolio, and also are of the riskier types that are aggressively-managed.

The purpose of any cash held is to handle any unexpected withdrawals, and to take advantage of perceived buying opportunities.

Aggressive investors are typically younger (The Invincibles), and intend to contribute relatively large amounts into the portfolio periodically over time via contributions coming from earned-income.

Most aggressive investors either want to accumulate substantial wealth in the future, are in a hurry, have enough income from other sources to fund their living expenses, and/or have plenty of time to work and recoup losses. Some just may have not yet personally experienced significant losses in the markets, so their bravery usually ends up being their own downfall.

They should know they would lose a very high percentage of their money if the markets go down, but also expect to profit greatly if they go up. Most all emphasis is put on making money and little, other than the diversification benefits of using mutual funds with asset allocation, is used in preventing the loss of money.

Aggressive portfolios produce the little-to-no annual income yields - typically in the range of 0% to 1%.

Aggressive portfolios produce a very high amount of capital gains distributions.

They are typically going to achieve long-term returns far greater than taxes and inflation. When the major markets are increasing, they expect to realize large double-digit returns. The typical range of annual returns in down financial markets are -15% to -5%, in flat markets -4 to 7%, and in up markets 8% to 12%.

**Back to Explaining the Reports**

In each of the other four sections on the Asset Allocation Calculator page, the row that you fit into is shaded.

Then all of the shaded numbers are totaled for each column by the eight major asset classes. This shows how much of your investments should be invested into each major asset class. The end-result is an asset allocation that’s tailored for your current life situation (the bottom colored row). In other words, this is the mix of major asset classes we feel will best fit your needs, today.

The asset classes are arranged (mostly) in order of riskiness going from left to right, as the colors indicate. Cash at the far left is green, going right the three types of bonds are blue, and the risky equities are shades of risky purples and reds.

We use eight distinct major asset classes, as shown in these reports. But when it comes to actually investing your money, we use up to 22 sub-asset classes (AKA buckets). These compress into eight because some sub-asset classes fit into one major asset class in the reports. This is because they are too similar to each other to be worthy of a separate major bucket in the reports.

For example, technology and biotechnology stocks have similar risk and return characteristics (back to MPT correlation coefficients again), so making a separate bucket for them in the reports would just add clutter with little benefit. Another reason is that the percentages recommended of the sub-asset classes are usually significantly smaller than other major asset class buckets.

You can see how this is working by looking at how the contents of each asset are distributed on the next page (CURRENT / OLD & PROPOSED / NEW ASSET ALLOCATION).

We rarely recommend over 2% in an Internet fund, whereas Large-cap Growth is commonly as much as 25%. How we allocate the sub-asset classes within the major asset classes are both a judgment and an optimization call (MPT again) based on our experience and your life situation, as explained below. For example, if someone scored Conservative and wanted monthly income to spend, we would raise the amount of real estate at the expense of tangible (natural resource) mutual funds in the right-most bucket.

For example, the Any kind of domestic stock other than Mid- or Large-cap Growth or Value stocks asset class has at least four types of U.S. equity securities inside of it:

• U.S. Small-cap, venture capital, privately held, and Micro-cap stocks.

• Mutual funds that specialize in small sectors of the market (technology, biotech, and the Internet).

• Other tangible funds / investments, like real estate and limited partnerships.

• Miscellaneous diversifying agents like inflation hedges, derivatives, IPOs, and venture capital funds.

This bottom-line allocation is just called the “Guideline” because there is no magic exact allocation that’s best for you. It would be impossible to calculate the perfect allocation except in rare situations (e.g., if a client wanted an exact income yield or a defined amount of money over a defined time frame). Even though there is no magic allocation, this part of the portfolio management process (calculating your guideline allocation based on your life factors) still adds the most value in tailoring a portfolio to your life and needs.

This allocation should also remain the same until something in your life changes (e.g., one of the five calculation sections, such as risk tolerance). It should not change in response to market moves, fear, irrational exuberance, or hot tips.

The next page (or two) titled CURRENT / OLD & PROPOSED / NEW ASSET ALLOCATION, shows how the money in your Current / Old portfolio(s) is or was distributed between asset classes. In other words, the way it is now, or how it was before our recommended changes are or were implemented (by trading).

The dollar amounts are shown to the right of the asset’s name. These amounts are all rounded to the nearest $100 or $1,000 most of the time, just because of the noise caused by normal daily market fluctuations.

Because a mutual fund may hold some cash, bonds, and some foreign assets, these amounts may be broken out into the different asset classes for each investment in the report. These numbers are shown to the right under the different asset class columns in the same row as the investment’s name and value. In other words, this section shows what’s “really” going on inside a complex investment, like a mutual fund or ETF. “Really” is in quotes, because this information is sketchy at best, for many reasons (so we’re doing the best we can, given the reality of what can actually be done in the real world).

To see the source of these numbers, take a look at any Morningstar mutual fund report at the end of the report (mid page at the top under the Composition section) and you will see that the fund’s value is usually spread between more than one asset class. This is how we determined (estimated) what you really have as best as possible (it will never be exact because fund managers only disclose this data monthly, and then it changes the next day when they trade).

There may be a separate page for both the personal and retirement accounts, or it could be combined into one page. Different accounts you may have may be segregated by putting an empty row / space between them. Sometimes if there's room, we'll put the name of the account in a blank row too.

At the bottom of these sections, all of your accounts are totaled up - by dollar values of personal, tax qualified (IRA) accounts, and then everything is combined and totaled.

We hope now it's now clear why we asked you for a list of all of your assets - not just assets that we manage. In order to give you the balance we feel is right for you, we need to know the whole story. Even if we don’t make any recommendations in investments you own outside of our management (e.g., your 401(k)s), the mix of assets under our management could be different depending on what you hold elsewhere.

For example, if you have a total of $1,000,000; $500,000 under our management, and you also own $500,000 of a Large-cap Growth stock outside of our management, we would not buy any Large-cap Growth mutual funds for you because we feel you already have way too much in this asset class already.

The next page shows the Guideline, Current, and the Proposed asset allocations summarized in pie chart form. This is where to look to make comparisons. There is also a four-bucket (stockbroker mentality) breakdown for easy reference on this page.

Because of various constraints on your assets, the Proposed allocation also probably won’t exactly match the Guideline. This is okay, because there are usually constraints or preferences on your part in the portfolio management process. An example of a constraint would be not wanting to sell a favorite stock.

The percentage you'll hold in each bucket will change daily as the markets fluctuate, too. What we want to do is keep each asset class’s allocation within a range, as explained in your Investment Policy Statement.

For example, your growth stock guideline may be 15%. This may change in response to normal market moves by a few percent every day. If your range is 15% to 5%, then we wouldn’t recommend selling some of this asset class unless it grew to be over 20% of your portfolio, and we wouldn’t recommend buying more unless it shrunk to be less than 10% or your portfolio. We check these ranges quarterly, when you tell us something in your life changed one of the five calculation sections, or when there is a significant change in your account (e.g., new money withdrawn or added).

The next page (or two) titled Proposed / New Asset Allocation, shows how we want to buy and sell investments in order to get closer to your Guideline allocation. The new (proposed) dollar amounts are shown next to the asset’s name, just like it is in the Current / Old Asset Allocation section.

Asset rows that are not colored are assets that you currently own that were not affected (nothing was sold and no new money was added to it). Assets that are colored “orange” are investments that you currently own that are recommended to be either sold off, partially or completely. Assets that are colored “blue” are investments that are either new by our recommended allocation, or are assets you have and we hypothetically allocated more money to go into them.

To see how much of an existing investment we want to change, subtract the value in the Proposed / New part of the report from the value in the Current / Old part of the report.

Please note that due to daily market fluctuations, and other variables, the actual dollar amounts in these reports will never be exactly the same as the actual amounts bought or sold in your account - unless someone has manually performed a linking process to your custodian’s reporting software.

The last color page of the asset allocation study is titled Source and Application of Funds. This shows how much is needed to buy and sell, both in percentage and dollar values, to reach your Guideline allocation in each asset class. This just compares your Current / Old position with the Guideline in dollar and percentage amounts. Nothing on the Proposed / New Asset Allocation, or the pie chart pages, has any effect on this page.

To summarize: We feel determining an asset allocation mix that best fits your life, and then using mutual funds in their respective categories to fill each asset class, is a sound risk-minimizing strategy we believe is most likely to enable your investments to reach your long-term goals.

We minimize the use of security selection and market timing because we know we can't see through walls (find out what's' really happening with a stock) nor predict the future, so we don't even try.

**Portfolio Projections and Forecasts**

The page, Annual Asset Growth of Current vs. Proposed Asset Allocations, then uses this asset level data to forecast the portfolios for future years, both in numeric and graphical form. This enables you to evaluate the long-term effects of making one trade.

Here we used some rate of return estimates for the eight major asset classes. Then the annual withdrawals and contributions may have been added to the picture. Then the changes in the asset class mix were added to that. The end result is the estimated growth of both the current and proposed portfolios over time. This information is also displayed in the graphs.

The asset allocation returns page shows both the current and proposed portfolio returns in several different formats. The returns input were the actual three-year annualized averages for each asset. If the data wasn’t available, then it was estimated.

Then the asset growth of the allocations page shows these numbers forecasted into the future.

One thing we can guarantee, is that not one of these guesstimated numbers will actually occur in the future!

**Miscellaneous**

Reaching your financial objectives will depend largely upon the management of your investment portfolios. Minimizing interest payments on debt and future cash flow surpluses that can be invested are also critical.

The primary goal of most investment strategies is to achieve a consistent after-tax rate of return, which matches your investment risk tolerance, is more than inflation, and meets your objectives.

Please call if you have any questions or would like more information.

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