## Newsletter for Asset Allocation Model Investors

**Real World Personal Finance Software**

**(503) 309-1369** support@toolsformoney.com <http://www.toolsformoney.com/>

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John & Mary Sample

999 Gotbucks Lane

Utopia, AZ 82345

Dear John & Mary,

This letter was written to give prospective clients information on how we manage money. Since many people like you want to know the details of what we would do with their money upfront, we feel it’s important to tell you as much as we can. So this answers the common question - “If we let you manage our money, what would you do with it?”

Overall, there are only three ways to manage money: Market timing, security selection, and asset allocation. The first two, in our opinion, involve too much guesswork and risk, so we take an approach that focuses on pure asset allocation. We’re not going to be guessing where any market is going, nor chasing hot stocks or ETFs with your money.

Asset allocation is the process of deciding what broad categories of investments to invest in, and then dividing up the money in your portfolio among them. These broad categories are called asset classes. The four most common examples of asset classes are cash, bonds, U.S. stocks, and stocks in other countries.

# We’d like to point out that you can have as much, or as little, control over your account as you want. If you want to own mutual funds, individual securities such as stocks, ETFs, or other types of investments that we don’t recommend, then we will work around that.

# Let’s say, for example, we determined you should have 20% of your money in the large-cap growth stock asset class, and you want to hold 30% of your money in Microsoft (a large-cap growth stock). We would just tell you what the risks and rewards are for being overweighted in an asset class, and if you still wanted to do it, then we would just not recommend buying a large-cap growth stock mutual fund.

The first step in the investment management process is Discovery or “Fact Finding.” This is where we give you an investment management questionnaire to fill out. If you compare the process to going to the doctor, Fact Finding is like getting a physical. Once the doctor gets to know you, recommendations can be made. This process is the same with financial planning and investment management - good recommendations are hard to make without getting to know you first.

Once the fact finder is filled out, we can determine which of five investment risk tolerance categories you best fit into. Because it summarizes how you feel about investment risk, this is the most important of the five life factors used to determine the mix of asset classes.

# Then we select mutual funds we feel best represent each asset class. These are the actual mutual funds you will own if you become a client. Both the asset classes and the mutual funds used are subject to change at any time without notice. If a fund is changed, the change would more than likely only apply to any new money that would come into the portfolio (unless something serious happened to the fund, then we may want to sell it out of your account). On average one mutual fund is changed every month for various reasons.

The Model's charts show the differences between the five most common risk tolerance categories - Conservative, Moderately Conservative, Moderate, Moderately Aggressive, and Aggressive. Our experience shows most people fall somewhere in these five ranges. All five Models use the same asset classes and mutual funds. The only differences between them are the percentages invested in each asset class and fund.

If your portfolio is over $250,000, the mix we will give you if you become a client won’t match these Models exactly, because your exact mix of asset classes is calculated on a custom basis specifically for you. Most everyone will have a slightly different mix depending on their life circumstances at the moment.

If your portfolio is less than $20,000, then we may not be able to buy all of the mutual funds listed in the Models. This is because most mutual funds have minimum initial investment amounts. For example, if a fund requires $2,500 to buy in from scratch, and your allocation calls for using 2.5% of this asset class/mutual fund, and you only have $75,000 total, there won’t be enough to buy into this fund ($75,000 x 2.5% = $1,875).

These five Model portfolio charts are designed to show you:

• The 16 asset classes we currently use, out of the dozens that can be invested in.

• The 15 (cash isn’t really in a mutual fund) mutual funds we use to represent each of the above asset classes, out of thousands that are available to invest in.

• How much, as a percentage of the total portfolio, of these asset classes / mutual funds we use for each of the five risk categories. This is shown in table and pie chart form.

• The total return of each mutual fund from the beginning of the year, until the market closing date shown on the top of each Model. Also shown is the performance for the last 12 months, yield over the last year, and the annual average over the last three years, as of the time we get our Morningstar updates. This is updated once a month and is always a few weeks behind.

• What the year-to-date total return, and last 12-month’s, and the annual average over the last three years has been when the funds are all weighted together on a portfolio basis. This is shown both before and after our estimated management fees and trading costs. These numbers take all of the internal mutual fund management fees and expenses into account already. These fees are shown on the Morningstar reports.

• What the year-to-date total return performance has been for six market indexes. These are the most common “broad market” barometers for five asset classes. The DJIA and the S&P 500 cover the broad U.S. stock market; NASDAQ is commonly used to track technology and small stocks; the Russell 2000 is used to track small stocks; the EAFE is used to gauge foreign stock markets; the BarCap Aggregate Bond Index is used to track the U.S. corporate and government bond market. We sometimes update all six of these index numbers daily. There is a more detailed explanation of each of these indexes below.

This is how you can tell what we will do with your money. For those who have a middle-of-the-road tolerance for investment risk, your portfolio will be very close to the Moderate Model. If you’re more concerned with minimizing losses than maximizing gains, then your portfolio will look more similar to the Conservative Model. If you are more concerned with maximizing gains than minimizing losses, then your portfolio will look similar to the Aggressive Model.

We have enclosed a Morningstar report for each of these 15 mutual funds. (Morningstar doesn’t generate reports for the first asset class - money market funds.) The longer-term track records and other important information can be found here.

For example, in the middle section called *Trailing-Period Performance*, you can see the total return from the beginning of the year (YTD) to the latest software release date (shown at the top in the middle). Also shown is the last 1 month’s return, last 3 months, and then the last 1, 3, 5, 10-year total returns.

If there is a “--” in this section, it means the fund wasn’t around that long. The numbers shown for periods of less than one year are not annualized. In other words, the 3-month return is just the return over the last three months - not the estimated annual return for the last three months and the next nine months combined.

The *Load-Adjusted Return %* numbers don’t apply because we get front-end loads (sales charges or commissions) waived when we buy these funds for you. This is because we are fee-based and not commission-based. We do not use back-end-loaded mutual funds at all. Dividends and capital gains are assumed to be reinvested back into each mutual fund.

We can also furnish you with a prospectus and annual report on these mutual funds. They should be read carefully before investing.

The performance data quoted represents past performance, and the return and principal value of an investment will fluctuate so that an investor’s shares, when redeemed, may be worth more or less than their original cost. None of these funds are insured by the FDIC, any government agency, or other corporation. Past performance is no indication of any future results. You can lose money by investing in these, or any, mutual funds.

We hope you found this informative, and that it answered your questions about what we would do with your money if you became our client. Thank you, and please call if you have any questions or would like more information.

**The Five Investment Risk 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 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-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 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 to a magic solution to this dilemma as humanity will ever create).

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 minimized, because they're "too risky," 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 -3% to +1%, in flat markets 2% to 5%, and in up markets 6% to 8%.

Conservative portfolios produce the highest annual income yields - typically in the range of 4% to 7%.

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 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 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 commodities that 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 6%.

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 -6% to -2%, in flat markets 1% to 7%, and in up markets 8% to 11%.

**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.

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 4%.

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 -4%, in flat markets 4% to 8%, and in up markets 9% to 14%.

**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 a little 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 3%.

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 0%, in flat markets -1% to 7%, and in up markets 10% to 15%.

**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.

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 -3 to 7%, and in up markets 15% to 25%.

Here is an explanation of the six indexes shown in the middle of the Model portfolios:

Dow Jones 30 Industrial Average (DJIA): A price-weighted average return attained by a diversified group of 30 major industry blue chip companies based in the U.S., whose value accounts for over one-fourth the value of the stocks listed on the NYSE. The stocks represented in this index may experience loss of invested principal, and are subject to investment risk.

S&P 500: A capitalization weighted index of 500 stocks traded on the New York Stock Exchange, American Stock Exchange, and Over the Counter, comprised of industrial, financial, transportation, and utility companies. The stocks represented in this index may experience loss of invested principal, and are subject to investment risk.

NASDAQ: A weighted average based on share price, measuring the performance of all shares traded Over the Counter, including foreign common stocks, and ADRs, but excluding warrants. The stocks represented in this index may experience loss of principal, and are subject to investment risk.

Russell 2000 Index: An index, including reinvested dividends, consisting of the 2000 smallest securities in the Russell 3000 Index. It represents approximately 11% of the Russell 3000 total market capitalization. This is a widely regarded small cap index. The stocks represented in this index may experience loss of invested principal, and are subject to investment risk.

Morgan Stanley EAFE Index: A total return index, reported in U.S. dollars, based on share prices and reinvested gross dividends, of approximately 1100 companies (only those securities deemed sufficiently liquid for trading by investors) from the following 20 countries: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Italy, Japan, Malaysia, Netherlands, New Zealand, Norway, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. The funds represented in this index may experience loss of invested principal, and are subject to investment risk. In exchange for greater growth potential, investments in foreign securities can have added risks. These include changes in currency rates, economic and monetary policy, differences in auditing standards, and risks related to political and economic developments.

BarCap Aggregate Bond Index: A total return index including corporate issues having a minimum maturity of at least one year, a minimum rating of AAA/AA by either S&P or Moody’s, and a minimum amount outstanding of US $100 million. Some bonds represented in this index are subject to investment risk, including loss of principal, if sold prior to maturity, and also to default.