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Mutual Funds

The perfect retirement portfolio

Safety is key after youve stopped working. Heres a low-risk yet productive strategy that defies conventional wisdom about sticking with bonds or CDs.

By Timothy Middleton

A month ago I wrote about an ideal portfolio for people saving for retirement (The perfect portfolio of funds). I subsequently got several e-mails from recent retirees asking if this portfolio was right for them.

My answer: Probably not. The portfolio I recommended was for someone building wealth to retire on. Someone who already has built up their retirement fund needs to worry about protecting it. A portfolio you have to live on should take less risk than a growth-oriented investment mix.

What should that portfolio look like? It will have more fixed-income funds, both to generate income and to hold down volatility. If you start with a nest egg of $500,000, this portfolio will enable you to generate a significant stream of income -- an inflation-adjusted $27,500 annually for at least 20 years, and probably more.

Hal Schweiger, a financial adviser with Capital Financial Advisors in San Diego, Calif., recommends a mix of 12 Vanguard mutual funds, some indexed and others organized according to style, such as growth or value. He picks Vanguard because it has the lowest expenses in the industry.

Stocking-up for retirement

Income will come from dividends and from selling a few fund shares each year. Also, you must rebalance the portfolio in order to maximize gains, Schweiger says.

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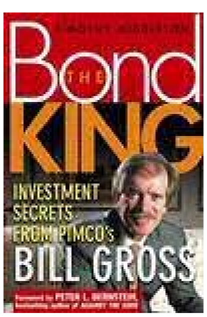

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The secret to making this work? Youll make more money in retirement from rising stock prices than the income paid by bonds. You should probably have a higher concentration of stocks than you are comfortable with, says David Longfritz, senior vice president of marketing for John Hancock Annuities. A Hancock annuity that I'll describe in a minute and Schweigers portfolio both guide you toward that seemingly aggressive mix.

Here is Schweigers recommended portfolio:

Security	% of assets	% yield
Equities		
Vanguard Value Index (VIVAX)	12	2.45
Vanguard 500 Index (VFINX)	12	1.99
Vanguard Small Cap Index (NAESX)	6	0.97
Vanguard Small Cap Value (VISVX)	6	1.58
Vanguard REIT Index (VGSIX)	6	4.63
Vanguard International Value (VTRIX)	6	1.44
Vanguard International Growth (VWIGX)	6	1.57
Vanguard Emerging Markets Stock (VEIEX)	6	1.53
Fixed income		
Vanguard Short-term Bond Index (VBISX)	10	3.42
Vanguard Short-term Federal (VSGBX)	10	3.15
Vanguard Intermediate-Term Bond Index (VBIIX)	10	4.79
Vanguard Intermediate Treasury (VFITX)	10	4.64

Note: Yields are as of Nov. 10, 2005.

Sources: MSN Money, Morningstar, Capital Financial Advisors

In terms of asset classes, this portfolio is in line with the classic balanced fund -- 60% stocks and 40% bonds. But most retirement investors are prejudiced against stocks, owing to their volatility. They would at least reverse these numbers, making it 60% bonds. Dont buy that approach.

All of these funds pay dividends, and you should take them in the form of cash as opposed to automatically reinvesting them. But dividends supply less than half of the portfolios annual return. The balance comes from capital appreciation.

A better way: Buy low, sell high

You can reap that harvest when you rebalance. Inevitably, some of these funds will have done better in a given year than others. So your first step is to sell enough shares of the best-performing funds to bring their weighting in the portfolio back to their original level.

You will likewise need to take enough profits from the winners to bring the weighting of the losers back to their starting point. The happy result of this discipline is that you will automatically be buying fund shares when they are relatively cheap and selling them when they are expensive.

If you were rebalancing this week, for example, based on the performance of these funds this year, you would be reaping profits first from the international funds. Vanguard International Growth is up 7.32% as of Nov. 10, International Value is ahead 9.38%, and Emerging Markets Stock has surged 19.28%.

This portfolio concentrates its fixed-income holdings in short-term bonds, which pay smaller dividends than long bonds. The reason is that short bonds are less sensitive to interest-rate swings than bonds with longer maturities. The more risk you take on in the form of rate swings, the more you get paid.

That is the theory, at least. This year, that textbook relationship has been violated by a phenomenon known as the flattening of the yield curve. Short-term rates, which are usually much lower than long-term rates, are nearly equal to long rates. Long-bond rates havent gone up, because investors dont think inflation will be high over the long term.

So long bond prices -- which move in the opposite direction of rates -- havent gone down the way short-term bond prices have. Vanguard Intermediate-Term Bond Index, which has an average maturity of 7.5 years, is down 0.09%, as of Nov. 10. Vanguard Long-Term Treasury, which has an average maturity of 17.2 years, is up 2.63%.

The behavior of this portfolio is a lesson in caution: It may not eke out the total return of 8.5% this year required to allow you to draw out $27,500 and still have your original $500,000, plus an extra 3% to match the inflation rate.

Inevitably there will be years like that. Just as inevitably, however, there will be years in which total returns will be twice the rate required for withdrawals. In those years, you need to limit your withdrawals to the planned amount in order to build a cushion for the lean years.

Corporate confidence

The odds that the market will shatter your retirement plans are not high. As witness, consider John Hancocks Venture variable annuity with what it calls the Principal Plus for Life rider. It promises to pay at least 5% of the portfolios value each year for life. If your initial $500,000 went to $100,000 in the first year, and never made it back to $500,000 in your lifetime, Hancock would lose money, because its going to pay you back at least $500,000 regardless.

What Hancock expects to happen, though, is that your purchasing power will actually increase over your expected 20-year lifespan, plus youll have money left over. In a best-case scenario Hancock calculated for me, someone who lived for 26 years after retirement would enjoy an income that gradually rose to the equivalent of more than $71,000 of todays dollars, plus leave a death benefit that would pay the surviving spouse an equal amount for a further 15 years.

Other insurance companies likewise offer high-octane annuities that rely on the historical ability of a mixture of equities and bonds to outpace inflation with a big enough margin to provide you -- and them -- an income.

So ignore the conventional wisdom that you need to lock up your retirement kitty in low-yielding bonds or certificates of deposit. You can have confidence youll be rewarded by taking a reasonable amount of investment risk with stocks.

And if youre still intimidated, buy an annuity. Youll get peace of mind and the insurance company will earn a handsome profit.

At the time of publication, Timothy Middleton didnt own any securities mentioned in this article.

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