

Sound Mind Investing

THE FINANCIAL NEWSLETTER FOR TODAY'S CHRISTIAN FAMILY

How To Balance Your Portfolio Between Investing-by-Lending and Investing-by-Owning

Once a year, you should evaluate the degree of risk present in your investment holdings. To help out, I'm sending along this special report to refresh your mind on the basics. In this article, I'll explain how to use the SMI risk categories to build a long-term investment portfolio which has a level of risk appropriate to your personal situation.

By Austin Pryor

One of the periodic chores investors must deal with from time to time is "rebalancing" their portfolios. It's like four people playing a game of Monopoly. Everybody starts out with 25% of the money, but after a few rounds of play, some are richer and some poorer. To get back where you started, you'd have to "rebalance" by taking money from some players and giving it to others.

Here's how that applies with our Sound Mind Portfolios. Let's assume you've been following our Vanguard Just-The-Basics strategy, and allocated your holdings along the lines suggested at the beginning of 2004 for those wishing to follow a portfolio mix of 80% stocks (invest-by-owning) and 20% interest-earning (invest-by-lending). You would have divided your money this way: 16% in the Vanguard International Growth fund, 32% in the Vanguard Extended Market fund, 32% in the Vanguard S&P 500 fund, and 20% in the Vanguard Total Bond fund.

In the months that follow, the percentages you started with begin to change as some funds do better than others. If the S&P 500 index fund does better than your other three funds, for example, it will soon represent *more than 32%* of your total holdings. How long do you let this continue before you step in and sell some of those shares in order to reduce your S&P 500 index holdings back to just 32% of your portfolio? How long, in other words, before you rebalance?

I suggest going through the process at least annually. In the SMI newsletter, I do it every January because, emotionally, it seems like a good time for new beginnings and getting a fresh start, but any month of your choice is fine. (Before you begin, it might be helpful to review the explanation of investing-by-lending and investing-by-owning found on page 4 of *JumpStart*.)

Now let's follow the steps taken by a hypothetical couple—Tom and Marilyn Randolph—as they adjust their portfolio to achieve the mix which they selected as best for them—40% stocks and 60% fixed income. (For more on how to

select the portfolio mix that is best for you, see pages 4-6 of *JumpStart*.) In developing this example, I assumed that Tom Randolph's 401(k) plan offers the typical choices: company stock, blue chip stock fund, long-term bond fund, and money market fund. Keep in mind that you don't need to *perfectly* achieve the recommended percentages. It's good enough to come close; when in doubt, go with less risk. Also, you don't have to change things all at once. If you like, take it in steps over a few years as your comfort level grows.

Step 1: List the current values of your assets.

Basically, this means writing down the investments over which you exercise control. Divide them into two groups: investments where you are an owner and investments where you are a lender (see pages 2-3 inside). There are two exceptions. Do not count the savings set aside for your Level Two contingency fund—they are not part of your long-term risk-taking strategy. Also, do not include money set aside for the children's education. These assets should go through their own remodeling process once you understand how to do it.

If you're married, put down both spouse's investments. Married partners are in this together— I discourage attempts to keep "his" money separate from "her" money. Also, as you can see from Tom and Marilyn's list, you don't need to distinguish between retirement or current savings, or when you bought them or what you paid. Nor do you care whether the investment is held in a normal brokerage account, an IRA, a 401(k), a variable annuity or any other legal structure in which investments are placed. The goal is to list on paper your various investments and the amount you would expect to receive if you sold or exchanged them.

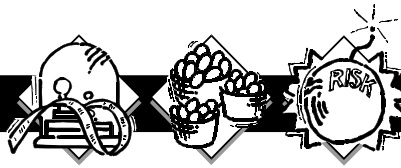
When you're finished, add up the totals and calculate what percentage each group represents in your total holdings. This is your first insight into how much risk you're taking in your portfolio. If you're like most people, your investments carry a higher overall risk level than you expected. *(continued on back cover)*



INVEST-BY-OWNING

(Risk Generally Decreases As You Move Down The Page)

What Goes Here	Some Examples	Your Current Holdings	Changes Needed	After Rebalancing
Include in this section any invest-by-owning investments that are not specifically named in the SMI strategy	Real Estate Ltd Partnerships and Rental Property			
		TOTAL		
Include in this section any international equity investments	Foreign companies owned as individual stocks or through mutual funds and variable annuities			
		TOTAL		
Include in this section equity investments that are designated as "special purpose" in the SMI strategy	Gold/Silver Coins Precious Metals Funds Single Sector Funds			
		TOTAL		
Include in this section investments that fall into Stock Risk Category 4: Small company, growth characteristics	Small, high p/e companies owned as individual stocks or through mutual funds and variable annuities	Marilyn's pension plan 6,000		6,000
		TOTAL \$6,000 9.8%		\$6,000 9.8%
Include in this section investments that fall into Stock Risk Category 3: Small company, value strategy	Small, lower p/e companies owned as individual stocks or through mutual funds and variable annuities			
		TOTAL		
Include in this section investments that fall into Stock Risk Category 2: Large company, growth characteristics	Large, high p/e companies owned as individual stocks or through mutual funds and variable annuities	Tom's 401k S&P 500 portfolio 8,300		8,300
		Tom's 401k G.E. stock 15,800	④ -5,700	10,100
		Goodyear shares 4,300	① -4,300	
		TOTAL \$28,400 46.6%		\$18,400 30.2%
Include in this section investments that fall into Stock Risk Category 1: Large company, value strategy	Large, lower p/e companies owned as individual stocks or through mutual funds and variable annuities	Utility shares 3,300	① -3,300	
		TOTAL \$3,300 5.4%		
		INVESTING BY OWNING \$37,700 61.8%	-\$13,300	\$24,400 40.0%



INVEST-BY-LENDING

(Risk Generally Decreases As You Move Down The Page)

What Goes Here	Some Examples	Your Current Holdings	Changes Needed	After Rebalancing
Include in this section any invest-by-lending investments that are not specifically named in the SMI strategy	Family Loans Fixed Annuity Church Bonds			
		TOTAL		
Include in this section "special purpose" bond investments	Zero Coupon Bonds Mortgage Bonds International Bonds			
		TOTAL		
Include in this section investments that fall into Bond Risk Category 4: Lower quality high-yield (junk) bonds	High-Yield (Junk) Bonds Tax-Free (Junk) Bonds			
		TOTAL		
Include in this section investments that fall into Bond Risk Category 3: Long-term, generally high quality	Bonds and bond funds with maturities greater than 10 years whether taxable or tax-free	Marilyn's pension plan 6,200		6,200
		Tom's 401k long-term govts 1,900	④ +4,100	6,000
		TOTAL \$8,100 13.3%		\$12,200 20.0%
Include in this section investments that fall into Bond Risk Category 2: Medium-term, generally high quality	Bonds and bond funds with maturities less than 10 years but greater than 4 years whether taxable or tax-free	Vanguard Intermed-Term Corp Bond	① +7,600	
		Vanguard Intermed-Term Corp Bond	② +3,000	
		Vanguard Intermed-Term Corp Bond	③ +1,600	12,200
		TOTAL \$12,200		20.0%
Include in this section investments that fall into Bond Risk Category 1: Short-term, generally high quality	Bonds and bond funds with maturities of 4 years or less whether taxable or tax-free	IBM bond (matures 6/2010) 3,000	② -3,000	
		TOTAL \$3,000 4.9%		
Include in this section cash-equivalent investments	Credit Union Savings Bank Savings / CD Money Market Fund Variable Annuity U.S. Treasury Bills	Tom's 401k money mrkt 4,600	④ +1,600	6,200
		Tom's IRA bank money mrkt 2,600		2,600
		Credit union joint savings 2,400	⑤ -1,600	800
		Marilyn's IRA bank money mrkt 2,600		2,600
		TOTAL \$12,200 20.0%		\$12,200 20.0%
		INVESTING BY LENDING \$23,300 38.2%	+ \$13,300	\$36,600 60.0%



Step 2: Determine what dollar changes are needed.

Now that the Randolphys know their current mix (62% equity and 38% fixed income), they can compute the dollar amount of the change needed to achieve the mix they seek (40% equity and 60% fixed income). Obviously, they will need to decrease the equity portion and increase the fixed income portion.

Here's how they calculate the dollar amount. They take the total value of their holdings of \$61,000 and multiply it times 40% to arrive at the equity portion goal—\$24,400. They then subtract this from their current equity portion of \$37,700 to learn how much of a decrease is needed.

This tells them that they need to sell \$13,300 worth of securities from the equity side and reinvest it over on the fixed income side. This will decrease their equity portion to \$24,400 (current \$37,700 less sales of \$13,300) while increasing the fixed income portion to \$36,600 (current \$23,300 plus new investments of \$13,300). Once this is done, their desired mix will have been accomplished.

Step 3: Decide which holdings to sell in order to meet your dollar goal.

The Randolphys now know they need to liquidate \$13,300 worth of their equity holdings—but which ones? Here are a few rules of thumb that might be of help in deciding.

- ◆ Keep in mind any limitations imposed by your pension holdings. For example, if Tom sells some of his 401(k) equity holdings, he can only reinvest the money in *other* 401(k) offerings. This limits the number of possible ways he can accomplish his goal.

- ◆ Move toward increased diversification. This means that Tom's large holding in his employer's stock (G.E.) could prudently be reduced.

- ◆ Sell a stock when the reason you

bought it is no longer valid. For whatever reason (the expected new product didn't pan out, the merger was called off, they didn't land the big government contract, etc.), the original case for investing in the stock no longer holds true.

- ◆ Don't worry. Many people fear "being wrong" and selling something that later goes higher. They're right to expect it, but wrong to think there's anything they can do about it. You can't know the future, so be realistic and accept your limited vision—don't let it paralyze you.

The Randolphys decide to sell their Goodyear and utility stocks plus however many of Tom's G.E. shares as necessary in order to reach a total of \$13,300. These moves are steps toward achieving greater diversification.

Step 4: Decide in which risk categories to make your new purchases.

Now that they have raised the \$13,300 to add to their fixed income portion, how do they decide *exactly* where to put it? Again, there are no absolute rules that govern this. Just as there is no single "right" route to take when driving across the country, there is no single "right" way to do your portfolio fine-tuning.

Let's assume the Randolphys decide to deal with the risk of rising interest rates by having roughly equal portions of their fixed income holdings in long-term bonds (over 10 years), medium-term bonds (over 4 years but less than 10 years), and money market funds and savings accounts. That means allocating \$12,200 (one-third of their fixed income portfolio of \$36,600) to each of the three categories. The targets were attained as follows:

- ① \$7,600 was raised by selling the Goodyear and utility stock, then invested in a new medium-term no-load bond fund at Vanguard.

(Note that once the Randolphys knew

the *kind* of investments they wanted to make, they selected a no-load mutual fund organization *that offered funds with demonstrated performance excellence in their area of interest*—bonds.)

- ② The \$3,000 IBM bond was sold and the proceeds were added to the new bond fund account also. This increased the diversification.

- ③ \$1,600 was withdrawn from their credit union savings and also added to the new account, making the total \$12,200.

- ④ In Tom's 401(k) plan, he sold \$5,700 worth of G.E. shares, transferring \$4,100 of it into the long-term bond fund and \$1,600 into the money market fund. Note that none of this money actually left the 401(k), it was moved around *within* it.

The Randolph's new portfolio is shown inside. Notice they didn't feel they needed to follow my allocation suggestions "to the letter of the law." They had the flexibility of adjusting their bond holdings to fit their personal situation and preference.

WRAPPING IT UP—FOR NOW

You control the level of risk you take by how you divide your money between the two choices—to invest by lending (lower risk) and to invest by owning (higher risk). Don't make decisions in isolation (e.g. should I renew this CD? or, should I change the mix in my 401(k) plan?) without taking into account *how the decision affects your overall mix*.

Scripture teaches that "To the Lord your God belongs the heavens, the earth and every thing in it" (Deut. 10:14). God has ownership rights; we have management responsibilities. That's why, whether you have many or few investments, doing your best to manage them in a God-pleasing manner is a task that must be taken seriously. It's a lifelong calling. ◆

IMPORTANT REMINDERS



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