BONUS REPORT $10

Sound Mind Investing

AMERICA'S PREMIER CHRISTIAN FINANCIAL NEWSLETTER

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. This special report will refresh your mind on the basics. I'll explain how to use the SMI risk categories to build a long-term investment portfolio that has a level of risk appropriate to your personal situation.

By Austin Pryor

One of the periodic tasks investors must deal with is "rebalancing" a portfolio. It's like four people playing a game of Monopoly. Each player starts out with 25% of the money, but after a few rounds of play, some are richer and some poorer. If you wanted to go back to 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 Investing portfolios. Let's assume you've been following our Vanguard Just-the-Basics strategy, and when you began, you allocated your holdings along the lines suggested 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 Total International Stock ETF, 32% in the Vanguard Extended Market ETF, 32% in the Vanguard S&P 500 ETF, and 20% in the Vanguard Total Bond Market ETF.

In the months that follow, the percentages you started with began to change as some funds did better than others. If the S&P 500 index fund did better than your other three funds, for example, before long it would 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 32% of your portfolio? How long, in other words, before you rebalance?

I suggest going through the rebalancing process at least annually. 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 may be helpful to review the explanation of investing-by-lending and investing-by-owning in the *SMI New Reader Guide.)*

Now let's follow the steps taken by a hypothetical couple — Tom and Marilyn Randolph — as they adjust their portfolio to achieve the mix they've selected as best for them — in this case, 40% stocks (including stock-based mutual funds) and 60% fixed income investments. (For more on how to select the portfolio mix that is best for you, see the *New Reader Guide.)* In developing this example, I assumed that Tom Randolph's work-based 401(k) plan offers the typical choices: company stock, blue-chip stock fund, long-term bond fund, and a 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 in which you are an owner and investments in which you are a lender (see the following pages). There are two exceptions. Do not count the savings in your Level One contingency fund — they aren't part of your long-term risk-taking strategy. Also, don't include money set aside for your 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 on the following pages, you don't need to distinguish between retirement or current savings, or identify when you made the investments 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 simply 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 the dollar amounts and calculate the percentage each group represents among 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.)

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						
		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, higher-risk companies owned as individual stocks or through mutual funds	Marilyn's pension plan	12,000			12,000	
		TOTAL	$12,000	9.8%		$12,000	9.8%
Include in this section investments that fall into Stock Risk Category 3: Small company, value strategy	Small, lower-risk companies owned as individual stocks or through mutual funds						
		TOTAL					
Include in this section investments that fall into Stock Risk Category 2: Large company, growth characteristics	Large, higher-risk companies owned as individual stocks or through mutual funds	Tom's 401k S&P 500 portfolio	16,600			16,600	
		Tom's 401k G.E. stock	31,600		❹ -11,400	20,200	
		Goodyear shares	8,600		❶ -8,600		
		TOTAL	$56,800	46.6%		$36,800	30.2%
Include in this section investments that fall into Stock Risk Category 1: Large company, value strategy	Large, lower-risk companies owned as individual stocks or through mutual funds	Utility shares	6,600		❶ -6,600		
		TOTAL	$6,600	5.4%			
		INVESTING BY OWNING	$75,400	61.8%	-$26,600	$48,800	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 12,400		12,400
		Tom's 401k long-term govts 3,800	❹ +8,200	12,000
		TOTAL $16,200 13.3%		$24,400 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	❶ +15,200	
		Vanguard Intermed-Term Corp Bond	❷ +6,000	
		Vanguard Intermed-Term Corp Bond	❸ +3,200	24,400
		TOTAL	$24,400	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 6/2021) 6,000	❷ -6,000	
		TOTAL $6,000 4.9%		
Include in this section cash-equivalent investments	Credit Union Savings Bank Savings / MMA / CD Money-Market Fund (MMF) Variable Annuity U.S. Treasury Bills	Tom's 401k money mrkt 9,200	❹ +3,200	12,400
		Tom's IRA bank money mrkt 5,200		5,200
		Credit union joint savings 4,800	❸ -3,200	1,600
		Marilyn's IRA bank money mrkt 2,600		5,200
		TOTAL $24,400 20.0%		$24,400 20.0%
		INVESTING BY LENDING $46,600 38.2%	+$26,600	$73,200 60.0%

Step 2: Determine the dollar changes needed.

Now that the Randolphs know their current mix (62% equity / 38% fixed income), they can compute the dollar amounts of the various changes needed to achieve the mix they seek (40% equity / 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 amounts. They take the total value of their holdings of $122,000 and multiply it times 40% to arrive at the equity portion goal — $48,800. They then subtract this from their current equity portion of $35,400 to learn how much of a decrease is needed.

This tells them that they need to sell $26,600 worth of securities from the equity side and reinvest it over on the fixed-income side. This will decrease their equity portion to $48,800 (the current $75,400 less sales of $26,600) while increasing the fixed-income portion to $73,200 (the current $46,600 plus new investments of $26,600). Once this is done, their desired mix will have been accomplished.

Step 3: Decide which holdings to sell to meet the dollar goal.

The Randolphs now know they need to liquidate $26,600 worth of their equity holdings — but which ones? Here are a few rules of thumb that may be of help in deciding.

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

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

◆ Sell when the reason you bought an investment 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.

Our hypothetical couple decides to sell their Goodyear and utility stocks, plus as many of Tom's G.E. shares as necessary to reach a total of $26,600. These moves are steps toward achieving greater diversification.

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

Now that Tom and Marilyn have raised $26,600 to add to the fixed-income portion of their portfolio, where do they put it? Again, there are no absolute rules that govern this kind of decision. Just as there is no "right" route to take when driving across the country, there is no single "right" way to fine-tune a portfolio.

Let's assume the Randolphs decide to deal with the risk of rising interest rates by placing roughly equal portions of their fixed-income holdings in long-term bonds (more than 10 years), medium-term bonds (more than 4 years but less than 10 years), and money-market funds and savings accounts. That means allocating $24,400 (one-third of their fixed income portfolio of $73,200) to each of the three categories. The targets were attained as follows:

❶ $15,200 was raised by selling the Goodyear and utility stock, then invested in a medium-term no-load bond fund or ETF at Vanguard.

(Note that once the Randolphs 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.)

❷ The $6,000 IBM bond was sold and the proceeds were added to the new bond fund account also. This increased the diversification.

❸ $3,200 was withdrawn from their credit union savings and also added to the new fund, bringing the total invested in medium-term bonds to $24,400.

❹ In Tom's 401(k) plan, he sold $11,400 worth of G.E. shares, transferring $8,200 of it into the long-term bond fund in his plan and moving $3,200 into the plan's money-market fund. (None of this money left the 401(k); it was moved around *within* it.)

BE FLEXIBLE, BUT BE WISE

It's worth noting that the Randolph's didn't follow SMI's allocation suggestions "to the letter." They adjusted their bond holdings to fit their personal situation and preference.

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). We urge you, however, not to make decisions in isolation (e.g., "Should I renew this CD?" or, "Should I change the mix in my 401(k) plan?"). Instead, take into account *how any decision affects your overall mix.*

Scripture teaches that "The LORD owns the world and everything in it" (Deuteronomy 10:14). That means God has ownership rights. We, in turn, have management responsibilities. Doing your best to manage your investments in a God-pleasing manner is a task that requires care and diligence. It's a lifelong calling. ◆

IMPORTANT REMINDERS