Employ an Aggressive Portfolio

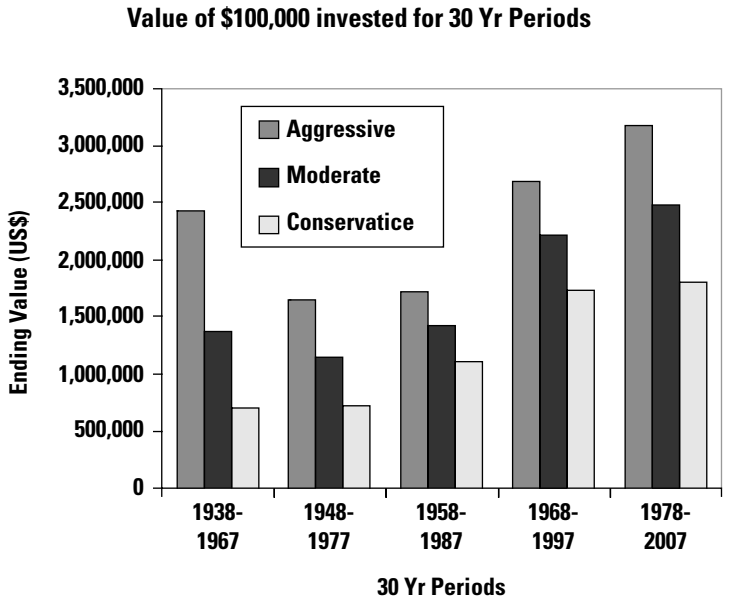
By Peggy Creveling, CFA

An aggressive portfolio bears nearly the full brunt of market volatility in an attempt to achieve higher long-term returns. There'll be more years of losses and more periods of multi-year losses, countered by some extremely good years of positive returns. You'll need to stomach large swings in the value of your portfolio, sometimes on a daily basis, without losing your nerve and bailing out on your portfolio. Your returns in any one year can vary widely, but the longer you hold the portfolio, the closer your return will approach the long-run expected return.

Is a portfolio that's earning only 1 to 2 percent more than a less volatile one worth the stress and anxiety? Over the long haul, yes. That additional 1 to 2 percent doesn't seem like much on its own, but compounded over a 20- to 30-year time period, the impact can be huge, as shown in Figure 50-1. For longer time periods, an aggressive portfolio is likely to do better than more conservative ones. The trick is having the ability to stay invested for long periods despite the turmoil you'll most likely experience. In this strategy, you explore aggressive portfolios.

TIP

Don't forget about mutual fund fees. You can sometimes add nearly 1 percent to your return by simply swapping your high-cost actively managed fund for a low-cost index fund or exchange-traded fund — and you don't need to take on any additional risk to get it.



Source: Moneyguide Pro/PIE Technologies historic data.

Figure 50-1: Comparing ending values of aggressive, moderate, and conservative portfolios.

Know Whether an Aggressive Portfolio Is Right for You

Consider an aggressive portfolio only if you meet the following conditions:

- **You have a long time horizon.** You need the extremely bad and good years to cancel each other out and settle around the longer-run expected return.

  With an aggressive portfolio, the long run should be 15 to 20 years or more. Anything shorter and your returns may be significantly lower than your expected return.

- **You have a high capacity to bear risk.** In other words, you can weather the storm financially if your investments don't work out within the time period expected. This may be because your goal is flexible or because you have a way to make up the shortfall by adding savings, extending the time period, or funding the goal from another source.

- **You're an experienced investor and know that you can stomach a lot of volatility.** The returns of an aggressive portfolio in any one year may vary widely. If you've invested during a prolonged period of market uncertainty before, you have a good idea of how you'll react when the financial media starts churning out stories of impending financial Armageddon. If you stuck through past periods without panicking and selling out, an aggressive portfolio allocation may be for you.

An aggressive portfolio isn't appropriate for all goals — the risk of shortfall is too high. Using an aggressive portfolio to fund college for your 13-year-old wouldn't be a good idea, but it may be appropriate for a younger person saving for retirement or even a retiree whose living expenses are covered by a pension or other income and is growing the portfolio to pass on to heirs.

If you're dependent on income from your portfolio, the risks of an aggressive portfolio may be unbearable. Making regular withdrawals, especially in years of bad returns, can devastate your portfolio and your life (see Strategy #68 for details). On the other hand, if you have an emergency fund in place, you have adequate health and long-term care insurance, and your essential living expenses are covered by Social Security, pensions, or other sources of income (not part-time work), then you may be able to take some additional risk with your portfolio. If you're primarily dependent on your portfolio to cover your basic living expenses, you don't.

In a household where more than one person is affected by the investment decisions, both need to be comfortable with the portfolio's level of volatility. Go with the risk tolerance level of the more conservative person.

Constructing an Aggressive Portfolio

Building an aggressive portfolio follows the same process as building moderate and conservative portfolios. You use the same asset classes for the level of portfolio complexity you prefer (see Strategy #48); only the weightings change.

An aggressive portfolio has a greater percentage invested in equity and alternative holdings and a lower percentage in fixed income. Experts suggest keeping equity and alternative investments in the 70-to-90-percent range and fixed income investments in the 10-to-30-percent range.

The same steps apply as with the conservative and moderate portfolios:

1. **Keep the overall split between the broad fixed income, equity, and alternative asset classes within the ranges shown in the following table.**
2. **Balance the number of asset classes with the size of your portfolio and your ability to manage it.**

   Use no more than 8 to 12.
3. **Allocate funds to each selected asset within the suggested ranges, ensuring that the total doesn't exceed the recommended range for the broader asset classes (fixed income, equity, or alternative).**

   Consider index funds and exchange-traded funds (ETFs) for each asset class to keep fees low. (See Strategies #21 and #23 for more on these funds.)

This table gives you some idea of how to split out the asset classes.

Asset Class	Holding Ranges (%)	Long-Term Historic Returns* Nominal (%)	Long-Term Historic Returns* Real (%)	Standard Deviation** (%)
Fixed Income	**10-30%**			
Cash*	0-5%	6.0	1.4	±2.9
Short-term bonds	0-15%	7.3	2.7	±4.1
Intermediate-term bonds	0-15%	8.0	3.3	±6.5
High-yield bonds	0-5%	9.2	4.8	±9.1
Global bonds (unhedged)	0-5%	8.4	3.7	±6.7
Equity	**60-90%**			
Large cap	25-50%			
Value		10.7	6.1	±15.4
Growth		10.2	5.6	±18.1
Small cap	10-20%	14.3	9.7	±22.2
International developed	10-20%	11.7	7.1	±21.4
Emerging markets	0-10%	11.6	7.0	±28.0
Alternative	**0-20%**			
Real estate investment trusts	0-20%	13.0	8.4	±17.1
Commodities	0-5%	11.7	5.6	±24.2

**Cash allocation is needed for portfolios where you'll be making withdrawals. L/T historic returns and standard deviation figures from Moneyguide Pro/PIE Technologies, 1972-2007 . Real returns based on the historical US inflation rate of 4.63% per year during the same period.*

Examples of Aggressive Portfolios

Following are some sample portfolios of differing complexity along with their historical performance. Find the portfolio that's most comfortable and appropriate for your needs by focusing on the bottom line — most return with lowest volatility or standard deviation.

Aggressive Portfolios

75% Equity and Alternative : 25% Cash and Fixed Income				90% Equity and Alternative : 10% Cash and Fixed Income			
Six Asset Class		**Twelve Asset Class**		**Six Asset Class**		**Twelve Asset Class**	
Cash	2%	Cash	2%	Cash	2%	Cash	2%
I/T Bonds	23%	S/T Bonds	7%	I/T Bonds	8%	I/T Bonds	5%
Large Cap	35%	I/T Bonds	10%	Large Cap	45%	Glbl Bonds	3%
Small Cap	15%	High Yield	3%	Small Cap	15%	Lg Value	19%
Int'l	15%	Glbl Bonds	3%	Int'l	20%	Lg Growth	15%
REIT	10%	Lg Value	18%	REIT	10%	Small Cap	15%
Total	**100%**	Lg Growth	14%	**Total**	**100%**	Europe	10%
		Small Cap	15%			Asia Pacific	10%
		Int'l Dev	10%			Emg Mkts	8%
		Emg Mkts	5%			REITs	10%
		REITs	10%			Cmmdities	3%
		Cmmdities	3%			**Total**	**100%**
		Total	**100%**				
Exp Rtn	10.8%	Exp Rtn	10.9%	Exp Rtn	11.3%	Exp Rtn	11.4%
Real Rtn	6.2%	Real Rtn	6.2%	Real Rtn	6.6%	Real Rtn	6.8%
Std Dev	11.8%	Std Dev	11.2%	Std Dev	13.9%	Std Dev	13.4%

Source: Portfolio expected returns and standard deviation figures from Moneyguide Pro/PIE -Technologies, based on historic returns from 1972-2007

Structure different portfolios to fund different goals. Your goals vary in terms of time horizon and importance and therefore impact your ability to handle a shortfall and market volatility.