November 2012 Issue

Motley Fool's *Rule Your Retirement* Newsletter

Follow the Fool's Rules for Asset Allocation

By Robert Brokamp, CFP

Less than a month from now, you'll be opening your door to strangers, giving them free stuff. (Don't worry, Fool, this is socially accepted on Halloween.) Once again, I expect to see lots of kids dressed up as characters from *Harry Potter*. I never read the books, but my kids are big fans, so of course I've heard that one of the central components is a prophecy that a boy born in July has the power to vanquish the bad guy. Stories involving predictions, oracles, soothsayers, and crystal balls seem to have lasting appeal among the trick-or-treat set: In my day, kids dressed up as fortune-tellers to try to score some candy. Not that I would know anything about that. Ahem.

On Wall Street, trying to predict the future and build a fortune goes on all year round, though we're about to get a specially timed earful as a parade of experts broadcast their forecasts for 2013. Sure, it's fun to hear predictions about how the stock market will perform in the short term, but any review of these annual prognostications reveals that their accuracy is as reliable as a carny's dental hygiene.

Let's look at an example from the Dec. 20, 2007, issue of *BusinessWeek*, which asked six well-paid, finely attired experts to estimate where the Dow Jones Industrial Average would be at the end of 2008. Here's what they saw when they read the Dow's palm:

- William Greiner, UMB Financial: 14,400
- Tobias Levkovich, Citigroup: 15,100
- Bernie Schaeffer, Schaeffer's Investment Research: 15,300
- Leo Grohowski, BNY Mellon Wealth Management: 14,800
- Thomas McManus, Banc of America Securities: 14,700
- David Bianco, UBS Investment Research: 15,250

As you likely recall, the Dow ended quite a bit lower on Dec. 31, 2008, than each of those predictions — about 40% lower, in fact, at 8,776. It was the worst year for the stock market since the Great Depression.

OK, so the credit crisis surprised a lot of us. But surely the people who saw it coming are better at predicting the future, right? People like Nouriel Roubini, the NYU professor who retroactively gained a lot of fame by warning of the coming housing crash? Well, let's see. In December 2008, *Fortune* asked Roubini for his predictions for 2009. Here's what he said: "For the next 12 months I would stay away from risky assets. I would stay away from the stock market. I would stay away from commodities. I would stay away from credit, both high-yield and high-grade. I would stay in cash or cash-like instruments such as short-term or longer-term government bonds. It's better to stay in things with low returns rather than to lose 50% of your wealth."

Unfortunately for those who heeded his advice, the assets Roubini warned against posted huge returns in 2009. As for the investments he recommended, the **Vanguard Short-Term Treasury Fund** (VFISX) returned just 1.4%, and the **Vanguard Long-Term Treasury Fund** (VUSTX) *lost* 12.1%.

If it sounds as if we're poking fun at these "experts," we are! But we're only mocking their activities, not their intelligence. The truth is that no one should be making any short-term predictions about the stock market. It's a waste of time, with no more chance of success than grabbing a rare Snickers out of a trick-or-treat bowl full of Good & Plenty boxes. (Well, historically, stocks have gone up in almost three out of every four years, but I can't keep that much chocolate in the house.) The truth is that the aforementioned people are very smart and have every financial resource available to them, but if they can't predict what the stock market will do in the next year, who can?

Use the Past to Prepare for the Future

Yet to gain financial freedom and prepare for retirement, we still have to invest, which is essentially a prediction of what will be more valuable in the future. So how should you handle this conundrum in your own portfolio? By looking to history. After all, we invest today because investing has (mostly) worked in the past. Let's look at some of that history, and then walk through the guidelines that have served as the bedrock of *RYR* investing.

For starters, the tables below show the returns of intermediate-term government bonds and large-cap U.S. stocks from 1926 to 2011.

Government Bonds	Best Average Annual Return	Worst Average Annual Return	% of Periods When Returns Were Positive
One year	29% (1982)	-5% (1994)	90
Five years	17% (1982-86)	1% (1955-59)	100
10 years	13% (1982-91)	1% (1947-56)	100
20 years	10% (1981-00)	1% (1940-59)	100

U.S. Stocks	Best Average Annual Return	Worst Average Annual Return	% of Periods When Returns Were Positive
One year	54% (1933)	-43% (1931)	72
Five years	29% (1995-99)	-13% (1928-32)	85
10 years	20% (1949-58)	-1% (1999-08)	95
20 years	18% (1980-99)	3% (1929-48)	100

So at least historically, it's paid to invest. In the next few issues of *RYR*, we'll explore the best ways to build a portfolio. But there's more to investing than simply buying funds and stocks you love. You need to make sure you're investing the proper amount of your total resources — while setting other money aside. For help with that, let's break out the Fool's Rules for Asset Allocation.

The Fool's Rules for Asset Allocation

Rule 1: Use cash for money you need in the next year.

Everyone should have some cash, at least in an emergency fund — you know, that boring blob of boodle you would access if there were an unexpected disruption to your income or an unwelcome eruption in your expenses. But some people should have more cash, proportionally, such as high-school seniors with college-savings accounts, or retirees (who have to cover expenses with a portfolio and not a paycheck). You don't want to lose a portion of the money for these expenses if bonds or stocks decline.

Rule 2: Choose CDs or bonds for money you need in the next one to five years.

History tells us that the more time you have until you need to cash in an investment, the greater the odds that stocks will pay off. But putting money you need in the next few years in the stock market is tempting financial fate. Keep it in safe individual bonds (such as Treasuries or very highly rated corporates), certificates of deposit (CDs), or short-term bond funds (though even these can drop in value, such as in 1994, when the average short-term bond fund fell 4.8%).

However, notice the word "need" in this Foolish Rule. If the goal for this money is more of a "want," or the date by which you could use the money is flexible, or you're just more willing to take risk, then you might choose a three-year safety zone. On the other hand, if you're more conservative, or the money must absolutely be kept safe, then extend that stock-free period to seven or more years.

Rule 3: Any money you don't need for more than five years is a candidate for the stock market.

The tables above show that stocks have posted positive returns in the large majority of periods beyond five years. But unfortunately, we don't know exactly when stocks will draw the short straw. Plus, there's no guarantee that history will repeat. Back in 1999, most of us were very optimistic about stocks; if someone told a typical investor that stocks would lose, on average, 1.4% a year over the next decade, he might have replied, "You're crazy! Stocks have never posted such a lousy 10-year return — not even during the Great Depression." And after 1999, when stocks returned 21%, it seemed that such a lousy decade-long performance would be impossible. But the subsequent nine years were so tumultuous that we have indeed recently experienced the worst decade for U.S. stocks in 86 years.

Still, it's important to remember what a stock is: part-ownership of a business. Some businesses don't do as well as expected, and some even go belly-up. But a diversified portfolio of promising, fairly priced businesses, including a heavy dose that operate all over the world, will grow as the global economy grows over the decades. We'll show you how to build such a portfolio in the coming months.

Rule 4: Always own stocks.

Bonds may be “safe” in terms of rarely losing money, but they’re also risky in terms of providing a good return, especially with current interest rates at all-time lows. Bond-heavy portfolios may not grow enough to meet your goals, and they almost certainly won’t keep up with inflation. For long-term investors, stocks have been the best vehicles to multiply your net worth and to ensure that your portfolio withstands inflation and your retirement spending.

Even if you’re in or near retirement, a portion of your money should be invested for the long term. That’s because a 55-year-old can expect to live another 26 years. A 65-year-old has another two decades. The average 75-year-old lives into her late 80s. (A 110-year-old, however, should sell everything and get to Vegas while he still can.) So unless you’re an overweight 85-year-old skydiver who smokes, expect your retirement to last two to three decades — and have the stocks to support it.

The Foolish Bottom Line

Because we don’t know what the future will bring, the smart strategy is to prepare for many possible outcomes. Be diversified, avoid wealth-destroying behaviors (such as trying to time the market), and follow another tenet of *RYR* investing: With your portfolio, be a short-term pessimist and long-term optimist. And hope that the next tarot-card-reading trick-or-treater who knocks on your door draws you the fool card, which can represent adventure, creativity, and a promising future!