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How to Invest Well and Sleep Better

In this devastated market, "risk tolerance" is an oxymoron. Those little tests the online investing sites give you to assess how much risk you can handle in your investments don't do justice to the kind of crash we're living through.

Most of us can't stomach 40% free-falls in our fortunes, and we certainly can't -- or don't want to -- suffer a shellacking like the one we had in October and then watch what's left trickle away day by day as it did last week.

You don't have to. This may be too late for many investors who have already seen their stock-heavy nest eggs scrambled, but some research and simple number-crunching indicates you can keep less money invested in stocks than conventional investing wisdom would have you believe -- without giving up your retirement goals and with a lot less risk.

It's All in the Mix

Indeed, a portfolio that mixes 50% stocks and 50% super-safe long-term U.S. Treasury bonds will perform almost as well over decades as a portfolio that carries an 80%-20% blend of stocks and bonds. And if you're the guy holding the first portfolio, you're probably sleeping a lot better these days than the other fellow.

"If your goal is to be very confident about having a certain amount of money at a point in time, lower-risk portfolios are actually a cheaper way to get there than a higher-risk portfolio," says Christopher Jones, of Financial Engines, an investment advisory firm.

If you, like many investors, have bailed out of stocks this year, you have, unfortunately, sold into the collapsing market and locked in your losses. But who could blame you? Most people can't handle the pain this market is inflicting. And the losses are worse because people nearing retirement often end up with way too much of their portfolios in stocks as they try to goose growth in their twilight years of working.

The typical investor's thinking goes something like this: Stocks over time outperform both bonds and cash. So without a high allocation to stocks, you'll fall short of your financial goal, inflation will ravage your portfolio, and your golden years will be tarnished as your money runs out before you do.

Big problem: The 80% or 70% stock portfolio that served you well in your 20s or 30s bites back in your 50s and 60s, when a crash erases years of growth in just a few weeks or months.

Start With a Balance

There has to be a better, more automatic way to build wealth without constantly refiguring your investment mix. There is. Forget the stock-heavy plan and start with an equal balance of stocks and bonds.

Let's look at what happens when you ratchet down stocks early to a less volatile level: We asked investment researcher Morningstar to calculate your investment results if at the end of October 1987 -- a really frightening moment, right after the big crash that year -- you had put 50% of your money in a low-cost fund that mimicked the Dow Jones Industrial Average and 50% in a vehicle that mirrored long-term Treasurys.

Nowadays that could be accomplished using the Dow "Diamonds" exchange-traded fund (DIA) and iShares Lehman 20+ Year Treasury Bond ETF (TLT). Over the decades, you would keep the allocation constant through annual rebalancing and would reinvest all stock dividends and bond income.

Good Enough Returns

The plan is to smooth your investment performance, accepting lesser short-term gains in exchange for milder, and less worrisome, short-term declines.

In this 21-year example, by October of this year a 50%-50% portfolio would have averaged a 10% annual return and you would have insulated yourself from a significant portion of the market's day-to-day risk. Your best quarterly performance? A 13.8% gain in the value of your portfolio. Your worst? A 9.1% loss.

By comparison, a portfolio of 80% stocks and 20% Treasurys would have been exposed to far more market risk, but your return would average just a slightly better 10.3% a year. Your best quarterly performance would have been an increase of 17.6% in your portfolio while your worst would have been a 14.2% loss.

In the current bear market, the 50%-50% portfolio would be down about 14.6% from the October 2007 market peak through the end of last month, while the 80%-20% portfolio would be down 24.8%.

Over the 21-year period, the 50%-50% portfolio would have achieved 95% of the total return of the 80%-20% mix, with substantially lower risk, a steadier performance and, for you, many fewer sleepless nights.

Not Much Difference

Make no mistake. The 50%-50% portfolio certainly will leave you poorer than the riskier blend. But the difference isn't that substantial.

Had you put $25,000 into the 80%-20% split in 1987 and never invested another dime, the money would have grown to $196,000. That same amount in the 50%-50% blend would be worth $185,000.

The strategy holds up if you dollar-cost average, too, and invest a little at a time over the years. Add $100 a month, and $25,000 grows to $261,621 in the 80%-20% portfolio and $251,732 in the 50%-50% mix.

Of course in bull markets, you won't make as much with a 50%-50% portfolio. You'll give up bragging rights. But you also won't feel the raw fear that others do during the inevitable downturns. That should be worth a few thousand dollars right there.

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