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A Portfolio That's as Simple as One, Two, Three

With so many funds to choose from, investors might get everything they need by buying just a few of them

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It may sound counterintuitive, but for the average individual investor, less is actually more.

With well over 8,000 mutual funds and exchange-traded funds at their fingertips, individual investors have never had more investment options from which to choose. But with all of that choice comes the potential for overload, and overwhelmed investors can make bad decisions or give in to impulses to chase returns from previously high-performing funds.

That is why some experts are pushing a back-to-basics approach to investing. As drastic as it may sound, they say it's possible—even at times desirable—to construct a very well-diversified portfolio using just three low-cost mutual funds or ETFs.

"In this atmosphere, where it's so easy to get drawn into complicated and niche areas of the market, this is a good way to be disciplined," says Abby Woodham, a fund analyst at investment researcher Morningstar Inc. MORN -5.48%

No International Bonds?

Which three funds to use? A classic trio provides exposure to U.S. stocks, foreign stocks and U.S. bonds.

Many "Bogleheads"—a group of investors who favor index investing as inspired by Vanguard Group founder John Bogle—suggest a three-fund portfolio consisting of the U.S.-focused Vanguard Total Stock Market Index fund, Vanguard Total International Stock Index, and Vanguard Total Bond Market Index . Together, the three mutual funds, which also offer ETF shares, track more than 15,000 global securities.

One possible allocation is 40% U.S. stocks, 20% international stocks and 40% bonds. That Vanguard portfolio, rebalanced annually, returned an average of 7.14% a year over the last decade, a little less than the 8.07% return of the Dow Jones U.S. Total Stock Market Index and the 8.62% return of the MSCI All Country World ex USA index, and well above the 4.52% return of the Barclays U.S. Aggregate Bond Index.

The approach is "simple to understand, simple to implement and simple to maintain," says Taylor Larimore, a member of the advisory board for the Bogleheads online forum.

"We would agree that this three-fund approach offers most investors a prudent, well-balanced, diversified portfolio at a low cost," says Vanguard spokesman John Woerth.

Similar low-cost portfolios can be constructed using ETFs from other providers, such as this trio from BlackRock Inc.'s BLK +2.47% iShares unit: iShares Core S&P Total U.S. Stock Market, ITOT +0.71% iShares Core MSCI Total International Stock IXUS +0.60% and iShares Core Total U.S. Bond Market AGG +0.10% .

Some financial pros and individual investors may quibble with this type of trio, saying asset classes such as international bonds aren't represented. "Having international exposure is crucial if you really want to have a diversified portfolio," says Paul Nikolai, principal and director at wealth-management firm Aspiriant in Cincinnati.

One way to include overseas bonds in a three-fund portfolio is to keep all of the stock exposure in a single global equity fund, such as SPDR MSCI ACWI IMI ACIM +1.21% from State Street Corp., STT +1.50% and split bond exposure into a U.S. fund and an international fund such as the Vanguard Total International Bond Index .

Most proponents of the three-fund approach believe that stocks and bonds are all the assets most long-term investors need. "It is often said that stocks let us eat well and bonds let us sleep well," says Mr. Larimore.

It is possible, however, to construct a three-fund portfolio that includes exposure to "alternative" strategies, or asset classes whose performance isn't closely correlated to that of stocks or bonds. Aspiriant's Mr. Nikolai suggests using a global stock fund and a global diversified bond fund, and saving a third, relatively small slice of the portfolio (think 5% to 10%) for exposure to an alternative strategy or asset class such as real-estate securities or a diversified basket of commodities. GS Connect S&P GSCI Enhanced Commodity Total Return Strategy Index exchange-traded note and Pimco CommodityRealReturn Strategy are two options.

One relatively new ETF that encompasses a variety of these alternative asset classes is SPDR SSgA Multi-Asset Real Return RLY +0.90% . It invests in everything from international real estate to commodities to natural resources and Treasury inflation-protected securities, or TIPS.

"I'm not recommending it to clients yet," says Mr. Nikolai, "but it's on our radar."

Pay Attention

In general, investors using a three-fund strategy should weight the three funds based on their time horizon—say, their expected retirement date—and risk tolerance. The longer the time horizon, the more aggressive a portfolio is likely to be, which typically means a higher weighting to stocks. A shorter time horizon often calls for a more conservative approach, usually with a higher weighting to bonds.

Experts also are quick to point out that even a simple portfolio needs tending—investors shouldn't just set it and forget it.

"The biggest pitfall [for all investors who decide on an asset mix and invest accordingly] is behavioral, when people don't want to rebalance," says Brad McMillan, chief investment officer at Commonwealth Financial Network in Waltham, Mass., and San Diego. For instance, if equities have taken a hit, you should consider buying more equities and selling off other asset classes, and "that's extraordinarily hard to do," he says.

Many advisers suggest rebalancing a portfolio at least once a year but encourage investors to check in on investments quarterly. With just three funds to rebalance, investors won't face the transaction fees they would if they had a larger number of ETFs to buy and sell, and it won't take an advanced mathematics degree to calculate them.

By contrast, "if you have 20 moving parts in your portfolio and you're managing it yourself, that's a huge undertaking," says Ms. Woodham of Morningstar.