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A Portfolio Entirely of Index Funds

By Jonathan Clements

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Regular readers of my columns and books know that, with tedious predictability, I recommend index funds. But which ones should you buy?

The choice has ballooned over the past decade. Today, there are 319 stock and bond index-mutual funds and 1,525 exchange-traded index funds in the U.S., according to Chicago investment researchers Morningstar. Thanks to all these funds, it's possible for investors to capture the performance of almost any market index imaginable, often at astonishingly low costs.

But how do you pick from among these funds, so you build a sensible index-fund portfolio? Here's how I tackle the problem.

Strong Core: I have roughly half my fund portfolio in three core index funds, which track the total U.S. stock market, international developed-market stocks and short-term corporate bonds. Want to keep your investment life simple? You could build a fine portfolio with just these three funds. The two stock funds will give you a shot at getting richer, while the bond fund will help ensure you don't end up poor.

Cash, not bonds: The late Peter Bernstein, an economist and best-selling author, argued in a 1989 article that a portfolio with 75% stocks and 25% cash investments, such as Treasury bills and money-market funds, was no riskier than a classic balanced portfolio, with its mix of 60% stocks and 40% bonds, and had generated superior returns.

I think about that argument as I look at today's investment choices. Stocks strike me as overpriced, but I'd still rather overweight them and skimp on bonds. Even if bond prices aren't clobbered by rising interest rates, returns will almost certainly be modest, given today's tiny yields.

Go for a money-market fund instead? It's tempting, but that would mean earning a zero yield. That's why I've taken a small step out on the maturity spectrum and opted for short-term corporate bonds instead. But my enthusiasm is tepid. A one-percentage-point rise in interest rates would wipe out two years' worth of yield, hardly a cheery prospect. Indeed, because of that risk, I also have a substantial portion of my "bond" money in short-term certificates of deposit, though the yields there are even worse.

Small stakes: What about the other half of my portfolio (the portion that isn't in my three core funds)? I look for parts of the market that might provide reasonable long-run performance in a low-return environment, while also offering added diversification.

To that end, I have dedicated exposure to international small-cap stocks, emerging-market stocks, emerging-market bonds, and U.S. and foreign real-estate investment trusts. None of these positions is huge. All the index funds are low-cost and easy to understand.

What about mutual funds and ETFs that pursue strategies typically associated with hedge funds? They, too, could be great ways to diversify. But they're too costly and complicated for my taste.

American values: As you'll gather, in my search for added diversification, I have often ended up investing abroad. Today, foreign stocks represent 36% of my stockholdings, up from 30% a few years ago. That, however, is still less than a market weighting. For instance, foreign stocks account for roughly half of the FTSE Global All Cap Index.

Why not invest more abroad? As I see it, most of my retirement money will be spent on U.S. goods and services, so I should match my assets with my future liabilities and keep most of my money in dollar-denominated investments.

Problem is, U.S. stocks are richly valued. To compensate, I've tilted toward value shares, those that appear cheap based on yardsticks like price-to-book value and price-earnings ratios.

Value stocks often hold up better in down markets, and historically they have delivered better returns than growth stocks. Value stocks also tend to pay higher dividends. Regularly returning cash to shareholders is, I believe, a good discipline for management. And if future stock returns are modest and I can collect, say, 3% in dividends every year, it won't take much share-price appreciation to notch a half-decent total return.

Stay balanced: For all the index funds mentioned above, I have target portfolio percentages. Occasionally, I rebalance back to these targets, moving money from the funds that have performed well to those that have lagged behind. That keeps my portfolio's risk level under control.

But rebalancing, especially among my stock funds, can also boost returns. As the underlying sectors cycle in and out of favor, my hope is to add a little to my portfolio's return by buying low and selling high. For instance, I have 5% of my stock portfolio earmarked for U.S. REITs. After 2013's lackluster performance, I bought REITs at the end of last year. But with 2014's rebound, my REITs are now above my 5% portfolio target. I'll likely be trimming those this year.