Sleeping Well at Night

To reduce sleep-interrupting worry, decide what portion of your portfolio to invest in cash and bonds. The following table tells you how much to put in bonds based on when you'll start withdrawing from the portfolio, and how long you'll be withdrawing for. Unless you have a terminal illness, we suggest you assume you'll be tapping into that money until age 100. And if a certain portion of your money is for future generations to spend or give to charity, think of their time frame, not yours.

The Bond Decision

The first step in creating your personal Rainbow Portfolio is to allocate your total investment assets to particular asset classes on paper. Your first decision is the bond decision: determining how much of your portfolio should be in corporate or government bonds and how much in the equities that make up the other asset classes. (We invest in high-quality government and corporate bond index funds only; junk bonds are out!) Figuring out that basic two-part split will fundamentally affect the amount of money you make from your investments. Here's why:

For all the myriad investment products available, there are still only two basic ways to invest: you either lend money to a company or real-estate project, or you own a piece of the company or the property. That is, you're either a bondholder (lender) or a stockholder/equity holder (owner). So the key driver of your Rainbow Portfolio is to determine how much stability-versus-volatility is right for you given your investment goals, inflation expectations, and the number of years your portfolio will need to fund. Where's your balance point between bonds and equities, the place where you feel comfortable that you're achieving sufficient returns yet you sleep well at night? Using the chart below

can help you find that point. Whatever you're investing for—retirement, paying for your daughter's wedding, roaming the world for years—there are two metrics for determining how much of your portfolio to allocate to bonds:

1. The number of years before you're going to start withdrawing money from the portfolio.
2. The number of years over which money is to be withdrawn.

Down the chart's vertical axis, find the number of years before you want to start withdrawing funds. Across the horizontal axis, identify the number of years over which you plan to withdraw the funds. Where the two meet is the percentage of your portfolio you should be allocating to bonds.

What Percentage Should You Invest in Bonds?

		Number of years over which money is to be withdrawn								
		0	**5**	**10**	**15**	**20**	**25**	**30**	**35**	**40**
Number of years before withdrawal of money begins	**1**	100	65	60	55	50	45	40	35	30
	2	80	60	55	50	45	35	35	30	25
	5	70	55	50	45	40	15	30	25	20
	10	40	35	30	25	20	5	10	5	0
	15	30	25	20	15	10	0	0	0	0
	20	25	20	15	10	5	0	0	0	0
	25	20	15	10	5	0	0	0	0	0
	30	15	10	5	0	0	0	0	0	0
	35	10	5	0	0	0	0	0	0	0
	40	5	0	0	0	0	0	0	0	0

Percentage points to add to your result to adjust for concern over volatility:

- If you check the markets **daily**, add **20** percentage points.
- If you check the market **weekly**, add **10** percentage points.
- If you check the market **monthly**, add **5** percentage points.
- If you don't check the market at all, no additions are necessary.

For example, if you're investing in order to have a lump sum of cash to pay for your daughter's wedding next year—that is, a once-only withdrawal one year away—you want 100 percent of your portfolio in bonds. If your dream is to spend five years globetrotting a decade from now, that's five years of withdrawals on the horizontal axis and 10 years before you start withdrawing on the vertical axis. Answer: you want 35 percent of your portfolio allocated to bonds.

Even though this allocation will likely lead to the best financial result, if you're too anxious to leave it alone, you may need to increase your bond allocation to compensate. Use the table below to set a floor on how much you need to invest in cash and bonds. Keep in mind this may mean you have to work longer or spend less to make ends meet, especially when you consider the other major financial risk—inflation.

What Percentage to Put in Bonds: Your Aversion to Short-Term Risk

Maximum loss you'll accept in a given year and stay invested	Minimum percent to allocate to bonds or money markets
0%	80%
15%	60%
20%	50%
30%	30%
40%	20%
>40%	0%

Picking your bond allocation is only the first part of taming the wild roller-coaster ride many people experience with investing. Before we tell you the second, let's play a little game: if you were given a choice between the following two portfolios, which do you think would grow your money the fastest?

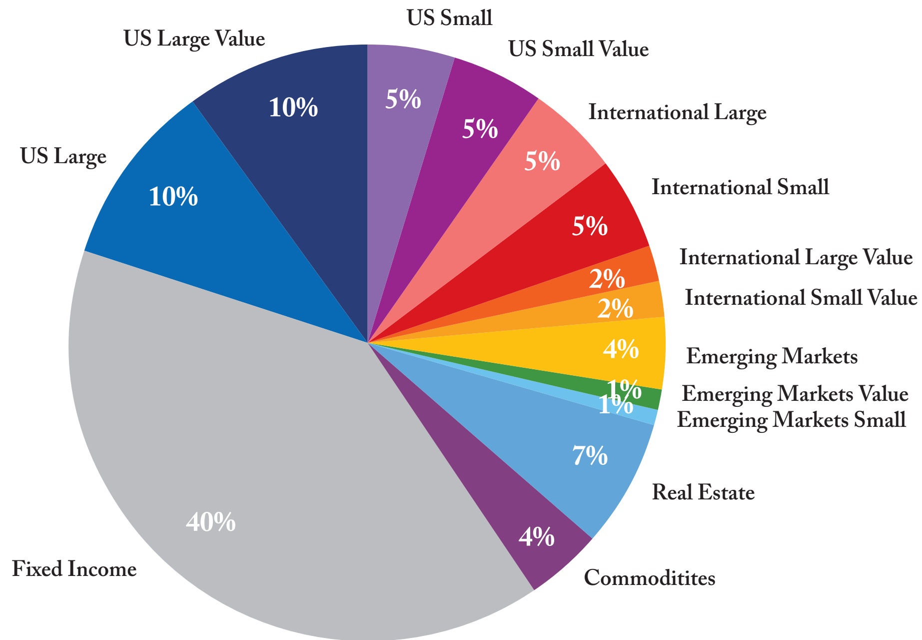
Which Portfolio Do You Think Earns More?

Portfolio	A's Returns	B's Returns
Year one	40%	10%
Year two	-20%	10%
Year three	10%	10%
Average	10%	10%

You might think that because these two portfolios have the same average return, they grow your money equally. Actually, in spite of the 40 percent gain that A experiences in the first year, B in fact earns more. Over the three-year period, a $100,000 investment in A grows to $123,200, while the same $100,000 in B will grow to $133,100—even though the two have the same 10 percent average return! It's the old tortoise and hare conundrum. The reason? B's smoother ride (known as "lower volatility" in investment lingo) means B has a much higher compound return, which is what dictates how much money you'll have at the end of the period.

Who wouldn't want a higher return with lower volatility? While finding an investment that will make 10 percent year-in and year-out without undue risk is difficult, the aim is to smooth out the ride (i.e., lower the volatility) of your investment portfolio. We recommend you do this by spreading around your investment to many different asset classes that don't all move in lockstep with each other. Below is an example of a Rainbow Portfolio for a client whose bond allocation is 40 percent.

Example of a Rainbow Portfolio



The reason there are so many colors in this portfolio isn't just so we could call it a rainbow. It's because each of these asset classes serves a specific function. The stocks and real estate give you the potential to reach a day when you may not have to work for every dollar you spend, and if you're already living off your portfolio, they'll help your portfolio keep pace with inflation. The bonds provide ballast in the inevitable storms that will come during financial crises. You'll note that the stocks are globally diversified, which is in keeping with the second principle described at the beginning of this chapter: namely, that we're all interconnected and our investments ought to reflect that fact.

And last, you'll see a healthy dose of the small and boring (small value) stocks that have historically provided tremendous growth compared

to other types of stocks. Most important, these asset classes smooth out the overall portfolio jitters. In this way, they're helping your money grow faster by reducing volatility.

The Rainbow Portfolio Equities Allocation

The table below will help you allocate your portfolio(s) among various stock, real estate, and commodity asset categories. Keep in mind that some investors should overweight or underweight some of these categories because of other holdings. For example, if you own quite a bit of investment real estate, you probably shouldn't be investing as much—or perhaps anything—in the real estate categories below. Likewise, if you have a rich aunt in London who plans to leave you her substantial portfolio of European stocks, you probably ought to reduce the international part of your portfolio compared to what's shown below.

Ideally, a fee-only, objective, S.E.C.-registered investment advisor who has your best interests at heart should build a personalized portfolio for you. For those who can't afford a professional—or don't want to hire one—we provide the following table to help you do it yourself. The column on the right refers to the NBA, or non-bonds allocation, which is essentially everything in your portfolio other than bonds and cash. So, multiply the percentages given by the non-cash and non-bond portion to figure out how much to invest in each category.

Where to Invest Your Non-Cash/Non-Bond Assets

Asset Class	NBA Percentage
Domestic real estate	15% x my NBA =
International real estate	4% x my NBA =
Commodities (gold, silver, oil, gas, etc.)	6% x my NBA =
U.S. large blend	16% x my NBA =
U.S. large value	16% x my NBA =
U.S. small blend	8% x my NBA =
U.S. small value	8% x my NBA =
International large value	9% x my NBA =
International small blend	4.5% x my NBA =
International small value	4.5% x my NBA =
Emerging markets large blend	3% x my NBA =
Emerging markets small blend	3% x my NBA =
Emerging markets value	3% x my NBA =

If your investment provider doesn't have certain categories, you may wish to combine similar funds (for example, all three emerging markets funds into one, or all the international funds into one). But you will be giving up some of the benefits in terms of expected returns and non-correlation discussed above.

Your Retirement Accounts

If you're like more and more Americans who work at a for-profit corporation, you're probably enrolled in the employer-sponsored retirement plan known as a 401(k). If you're employed in the non-profit universe, you might be part of a 403(b). Government workers on the local, state, or federal levels may enroll in a 457 plan or other variant.

If you participate in one of these plans, good for you! The advantages of these employer-sponsored retirement plans are pretty amazing. We tell our clients that if they do the math, they'll see that these plans are the most underrated gift in human history! All are tax-deferred, meaning you won't pay any taxes on either your plan contributions or your earnings from it until you actually withdraw the money. As if that weren't enough incentive to invest in these plans, many employers match some or all of each employee's contribution—in some cases actually doubling what you put in. That's like free money. And for those who find it hard to keep track of such things, most plans also offer an automatic contribution mechanism, so the amount you choose to invest is automatically deducted from your paycheck and directed into your investment account.

In other words, these plans make it attractive and easy to save and invest money for retirement. Under the circumstances, you'd think corporate employees would be chomping at the bit to sign up.

You'd be wrong. In a pervasive kind of money madness, 30 percent of workers eligible for retirement plans don't bother to participate. Seventy percent of those who do participate invest primarily—some almost exclusively—in *their company's* stock, despite such dramatic disasters as Enron and Bear Stearns, in which many employees who were invested in the company stock lost it all. And nearly half of participants don't contribute enough to get the full company match, which is like saying no to free money.

We all know that Americans are notorious for not saving—even when these 401(k) plans make it easy. At the high end of the earning scale, perhaps the indifference is part of that old money-madness idea that you can beat your company-sponsored retirement plan by managing your own investments. Because investing on your own pits you against the headwind of taxes, that's hard to do; if the funds available through your company plan return an average of 10 percent, you'd have to realize at least 12 percent to do better—highly unlikely. Among people living paycheck to paycheck, the madness is

that when most people get a raise, they raise their spending as well—and live paycheck to paycheck at a higher income, still not saving.

Either way, given the tax deferment and, where offered, the incentive of employer-matched contributions, it's madness to disdain these plans. Even a Warren Buffett would be challenged to beat a 401(k) that has a matching feature—especially if the match is substantive. That's why we recommend doing just about whatever you have to do to invest in these plans. If you find it difficult to save, start small. Make the minimum contribution possible at first, then ask your employer to increase it over time. If you feel strapped for cash, take some out of other savings—even borrow money!—to take advantage of a 401(k) plan with a match. It's that good an investment vehicle.

The Rainbow Portfolio and Your Employer-Sponsored Retirement Plan

As much as possible, your aim should be to make your 401(k) an essential part of your overall personal Rainbow Portfolio. Most 401(k)s won't be able to offer the Rainbow Portfolio's 14 asset classes, but you can still use other resources, if available, to invest on your own to complement the 401(k).

The first thing to do is to check the investment options available in your employer's retirement plan. Most offer a menu of funds, which, in order to comply with Department of Labor standards, run the gamut of risk from conservative to aggressive and everything in between. Yet as far as asset class diversification is concerned, employer-sponsored retirement plans pretty much limit themselves to the four standards: large-cap U.S. growth, large-cap U.S. value, large international growth, and bonds or fixed income. To find out which asset classes are available in your employer's menu of funds, you can look at each fund's literature, which is usually offered online or can be mailed

to you at your request. In addition, there are mutual-fund rating services, like Morningstar, that categorize virtually all funds by asset class.

Keep in mind that it's possible for a fund to represent more than one asset class. For example, if ABC Mutual Fund is 75 percent invested in U.S. large-growth stocks and 25 percent in international large growth, you need to be aware that's how your money is allocated; in a sense, you're "catching" two asset classes with one fund. In any event, once you find out which asset class or classes your employer's plan gives you access to, you at least know where you are—and where and how far you need to go to reach the 14-asset-class mark of the Rainbow Portfolio.

With your non-retirement plan savings, you should target the 14 asset classes, and especially the ones you cannot get through your employer plan, using a financial advisor or by do-it-yourself mutual-fund investing. This way, you reap the advantages of your employer-sponsored plan—the tax deferment, the matching funds, the convenience—and the gains of the Rainbow Portfolio.

Another easy way to gain such advantages is to roll over retirement plans from previous employers into an IRA rollover account where you can take advantage of the increased number of asset class offerings to supplement your current 401(k). The ultimate goal here too, of course, is a total portfolio that profiles the 14 asset classes of the Rainbow Portfolio.

As to investing in your company stock, don't. You're already subject to the risks and rewards of your company's future through your employment there; in a very real sense, you're already correlated to its performance. Why invest in its stock as well? Since 42 percent of total 401(k) assets are invested in the company's stock, your aim should be to diversify away from that concentration. Of course, if you can buy your company's stock at a discount, buying it and selling it quickly may offer you a gain that you can then diversify into investments representing varied asset classes—a full rainbow of them. But if participating in your employer-sponsored retirement plan is all you can afford, just try to make that plan as close to the Rainbow Portfolio as possible.

Don't forget that as an employee, you can potentially help expand your company's retirement plan offering. You do have a say in the matter. The Investment Company Institute of Washington, D.C. estimates that as of year-end 2006, some 80 million of us were enrolled in such plans, representing investments totaling more than $4.1 trillion. Those numbers ought to constitute a pretty good-sized bullhorn. And as it happens, now is a particularly good time to advocate for bringing the benefits of the Rainbow Portfolio to your organization's plan. The reason is that plan sponsors—that is, employers who set up retirement plans—are under increasing pressure to answer for the plans in terms of risk and performance. Lawsuits have been brought charging that certain plan sponsors didn't keep the fees reasonable enough. One result is that plan sponsors are more interested than ever in making sure employees are happy with the plans.

Now may be a good time to try inspiring your employer to offer funds that cover as many of the 14 asset classes of the Rainbow Portfolio as possible—and that manage those investments passively. With employers in a persuadable frame of mind, you might just want to remind them that making more money with less volatility—through a greater number of asset classes, not just fund choices, and through passive investing, not frenzied active management—can lead to less financially stressed employees, higher plan participation, and greater retention of valuable employees, all of which sponsors want.

Buying Low and Selling High

Once you've allocated your assets, you must institute a very important ongoing discipline called "rebalancing," in which you periodically re-allocate your portfolio back to its originally established targets. Take a look at a simple example: Let's say your portfolio is allocated 40 percent to a

large-stock index fund, 20 percent to a small-stock index fund, and 40 percent to a short-term bond fund. If the stock market (including both large and small stocks, goes up 30 percent and bonds stay flat, you're now going to have 66 percent of your assets in stocks and only 34 percent in bonds.

In this example, rebalancing mandates that you sell your large stocks down to 40 percent of the new higher-total portfolio value and your small stocks down to 20 percent of the total. You should then use the proceeds to buy your bonds back up to 40 percent. This forces you to sell what has just appreciated and buy what has just gone down in value, relatively speaking. Most investors do just the opposite—they buy more of what's gone up, and often sell what's gone down. Over the long run, this is akin to buying high and selling low, whereas successful investors obviously want to do the opposite. Rebalancing will require you to go against your emotional instincts fairly often, but it is practiced by the majority of the country's most successful investors and is considered a best practice in the investment management industry.

Many investors wonder how long to hold on to their "winners"—the assets that have appreciated most dramatically. Most hold on too long. Rebalancing forces us to sell our winners and reinvest in those asset classes that have appreciated less. You might wonder just how often one ought to rebalance. Most professional investors choose to rebalance at periodic intervals, such as every calendar year, or they pick an acceptable range within which each asset class can move without generating a trade. For example, if your portfolio has a target of 40 percent U.S. large stocks, then you might set an acceptable range of 32 to 48 percent so that if that asset class gets below 32 percent, you'll buy more of it, or if above 48 percent, you'll sell some of it. How much? Just enough to get back down to your target allocation.

Rebalancing Worksheet

Use this table to help you rebalance (everything needs to add up to 100%):

Asset Class	Target Percent	Current Percent	Percent to Buy (or Sell)	Target Amount	Current Amount	Amount to Buy (or Sell)
e.g., U.S. small stocks	7%	11%	(4%)	$70,000	$110,000	($40,000)

Don't forget about taxes. You probably don't want to rebalance a non-retirement account and sell a holding that's appreciated greatly if you've only owned it for 10 to 11 months. By waiting just a month or two more, you could get long-term capital-gains tax treatment, which for most is much lower than short-term gains (on investments held less than 12 months) that are taxed at your ordinary income tax rates. For our latest investment recommendations for do-it-yourself investors, please visit spiritandmoneyworkshop.com/doityourself.

We're aware that this chapter has presented a lot of practical, nuts-and-bolts investing advice—some of it quite complex. However, we feel that investing is one of the easiest ways to align our personal finances with spirit. What's more, we don't have to suffer financially in the process. The results of this type of investing often outperform the results of typical investors who aren't making any attempt to incorporate these self- and spirit-affirming principles.