MORNINGSTAR®

The Guide To Investing
Crafting a Satisfying Financial Plan

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Bringing "One and Done" Gratification to Your Financial Plan

You've probably heard about studies showing that the typical American spends more time researching vacation destinations than crafting a financial plan. And let's be honest here: Did financial planning even have a chance? After all, thoughts of vacation are happy ones, whether your idea of a good trip is a trek in the Himalayas or lying on the beach with the sole occupation of keeping sand out of your cocktail. Financial planning, meanwhile, conjures up drudgery for most of us: spreadsheets, calculators, financial statements — in short, something that feels a whole lot like our day jobs. For many, the thought of getting elbow-deep in their finances feels even worse than a day job — probably not surprising given that we're coming through a period of stagnant wage growth for most earners, a housing market bust and two major bear markets over the past few decades. But I think there's another reason people get into vacation planning more than they do their financial lives. The former is one and done: Spend a few hours researching potential spots, consult with fellow travelers on the plan and book it. At the end, you have a feeling of satisfaction and something to look forward to.

Crafting a financial plan, meanwhile, is not one and done at all. It's a process, something that you're going to have to keep toiling at for the rest of your life. But does it have to be that way? I'd say no. Individuals can bring a bit of "one and done" gratification to their financial plans by tackling their key financial tasks one at a time rather than viewing them as a time-sucking, soulcrushing black hole of obligation.

Helping you cross some of those key financial planning tasks off your list is the focus of this supplement. Harnessing research and guidance from Morningstar.com, this guide is designed to help you knock off 21 discrete specific financial planning jobs, one by one. Some of these tasks fall into the category of financial-planning 101—crafting a budget and making sure you have an adequate emergency fund, for example. Others, such as reducing the drag of taxes on your portfolio or testing retirement readiness, are appropriate for more seasoned investors. If you feel like you're in good shape on one of the tasks or it's not relevant to your financial life, you can move on to the next one. And even if you don't make it all the way through all 21 jobs, our goal is that you'll end up more financially fit than you started out.

We've augmented the core 21 Days to Financial Fitness blueprint with worksheets that can help you execute specific tasks. And to help provide a greater level of detail on complex topics like IRAs, 401(k)s and Social Security, we've included supplementary articles. As always, you can count on

Morningstar guidance to be objective — that is, we don't have a vested interest in whether you choose to do business with one financial provider over another, or whether you buy individual stocks, mutual funds or exchange-traded funds. The goal of this supplement, and all of our work on Morningstar.com, is to help individual investors improve their financial well-being so they can enjoy the nonfinancial parts of their lives. Like vacation. M

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Section 1
Develop Your Plan

Develop Your Plan

21 Days To Financial Fitness

Morningstar's Christine Benz offers a step-by-step guide to getting in peak financial shape.

By Christine Benz

"To change one's life, start immediately, do it flamboyantly, no exceptions."
— William James

James, a psychologist, was right on the money with the "immediate" part. But does enacting lasting change in your life need to be momentous or flamboyant? Nah.

Instead, most people who have achieved big goals will tell you they've done so little by little, one small step at a time. The person who lost 30 pounds did so by walking an extra mile a day and putting skim milk in her coffee instead of half and half. The author who wrote a best-selling first novel got it done by writing a few pages a night, after he had put his kids to bed.

The same is true when you're aiming to achieve your investing goals. The broad goals of funding a comfortable retirement, paying for college, or buying a first home can seem daunting, particularly when you think through the dollar amounts that you'll need to save. But if you break these broad goals down into smaller, more manageable tasks, and tackle them one at a time, you can begin to make real progress toward your goals.

In this article I'll coach you on completing one investment task per day, with an eye toward getting in the best financial shape of your life. I'll discuss how to invest for goals that are close at hand, how to build a retirement portfolio, and how to make sure your investments are on track from year to year. In just three weeks, you can be financially fit!

Day 1: Start tracking your expenses
Degree of Difficulty: Easy

Let's start with a fairly easy task: beginning to track your spending habits. There are Web sites, apps, and financial software programs devoted to helping keep close tabs on your household's cash flows, but tracking your expenses can be as simple as jotting them down whenever you find yourself opening your wallet or writing a check. Group your expenses into one of two main categories: fixed (i.e., spending that doesn't change and you can't do without) and discretionary. Get a start with the Budget Worksheet included here.

Plan to keep track of your expenses for at least a month; that way you can identify patterns in your spending and zero in on your problem spots. Examining cash flows in this way is the first step in creating a budget that aligns with your priorities and the realities of your life. You may also find that tracking your expenditures will have the salutary effect of causing you to think twice before spending money on things you don't necessarily need.

Day 2: Take stock of your assets and liabilities

Degree of Difficulty: Moderate

Now that you're getting warmed up, it's time to move on to the key task that will show you how you're doing financially: checking up on your net worth.

If you keep good records and don't have many financial accounts, enumerating your assets and liabilities will be pretty straightforward and shouldn't be time-consuming. You've got more work ahead of you if your records and portfolio are in a state of sprawl, but think of this as your impetus to streamline and get organized.

You don't need to get especially fancy; get started with the Net Worth Worksheet included here. To document your assets, simply retrieve your latest account balances and estimate the worth of your personal possessions, including real estate. On the other side of the ledger, record any debts you owe, including your mortgage; student, home equity, or auto loans; and credit card balances. Subtract your liabilities from your assets and you're looking at your net worth.

If your net worth is negative or barely positive, you've got your work cut out for you. Creating and sticking to a budget should be a key priority in the years ahead. And even if your net worth is comfortably positive, you should still spend time digging into the numbers. Is most of your money tied up in a single asset, such as company stock or your house? If so, a key goal should be to diversify your financial assets in the years ahead. Do you have an adequate amount—six months' worth of living expenses at a minimum—stashed in an emergency fund? If you don't, prioritize building up your position in ultrasafe (and unfortunately, ultra-low-yielding) investments before investing in longer-term assets like stocks.

Day 3: Check your emergency fund

Degree of Difficulty: Easy

Before you begin saving for your long-term goals, it's crucial that you build an emergency fund—a basket of ultra-liquid investments that you can tap in case you lose your job or confront an unanticipated car or home repair.

The typical rule of thumb is to keep three to six months' worth of living expenses in your emergency fund. But perhaps a better way to decide how much to store in cash is to think about how much

Budget Worksheet

WHAT YOU'LL NEED

- A record of your monthly income and expenses
- A list of your goals, along with when you hope to achieve them and how much they'll cost

MONTHLY INCOME

Salary (net: after taxes and benefits)	
Spouse's salary (net: after taxes and benefits)	
Social Security/pension	
Interest/investment income	
Other income (specify)	
TOTAL: Monthly Income Amount	

MONTHLY EXPENSES

Fixed	**Spent**	**Budget**
Mortgage or rent		
Property tax, HOA fees, etc.		
Auto loan		
Tuition/student loans		
Credit card payment		
Utilities		
Child care		
Food		
Clothing		
Insurance		
Other (specify)		

Variable	**Spent**	**Budget**
Personal care (gym membership, etc)		
Entertainment		
Dining out		
Other (specify)		
TOTAL: Monthly Expenses Amount		

Income		Budget		Your Savings Target
	–		=	

Net Worth Worksheet

Find out how much your assets are worth in total by filling out this worksheet. List assets by ownership.

WHAT YOU'LL NEED

- Most recent investment statements for taxable accounts, retirement accounts, and college savings plans
- Most recent checking and savings account statements
- An estimate of the current market value for your home(s)
- An estimate of the current market value of other assets, including cars, jewelry, artwork, etc
- Life insurance policy face values
- Most recent credit card statement(s), if you have a balance on your account
- Most recent mortgage and home equity loan statements
- Most recent statements from any other debts you owe, such as student or auto loans

ASSETS

Taxable Accounts	You	Spouse	Joint	Total
Checking, savings, CDs, etc.				
Taxable investments (stocks, bonds)				
Other				

Retirement Accounts	You	Spouse	Joint	Total
401(k), 403(b), 457				
Traditional IRAs				
Roth IRAs				
Annuities				
Other				

Personal Property	You	Spouse	Joint	Total
Real estate (primary and secondary)				
Cars				
Other (jewelry, furs, art)				
Home furnishings				
Life insurance cash value				
Other				
TOTAL: Assets				

DEBT

	You	Spouse	Joint	Total
Mortgage/home equity loan				
Car loan				
Credit card debt				
Student loans				
Other				
TOTAL: Debt				

Total Assets		Total Debt		Your Net Worth
	–		=	

of a cushion you'd like to have in case you lost your job. If you go through that exercise, you're apt to conclude that three months' worth of living expenses is nowhere near enough. But don't go overboard with your cash hoard, either. After all, interest rates on money market accounts and funds are low, so being too conservative has an opportunity cost. As you calculate your emergency-fund requirement, don't use your real spending patterns to set your living expenses. Think about how much you could get by on in a pinch, excluding dinners out, house cleaners, and vacations.

Compare your emergency-fund target with the amount you have saved in CDs, money market accounts and funds, and checking and savings accounts. Don't include cash holdings that appear in long-term mutual funds. Building your emergency fund up to your target level should trump saving and investing for other goals, such as retirement or college.

Day 4: Get maximum mileage from your cash holdings
Degree of difficulty: Easy to moderate

Everyone needs cash, both for an emergency fund and to cover upcoming expenses such as your property tax bill or college tuition. Keeping that money safe is important, but the big drawback is that yields on CDs, money market accounts, and other cashlike vehicles are about as low as they can go right now.

When shopping for the best yields on cash investments, the list of don'ts is almost as long as the list of dos. While it's smart to be opportunistic and scout around for the best yields, my key piece of advice is not to get too cute. Safety is key for this portion of your portfolio, so resist the temptation to park some or all of your assets into a "cashlike" vehicle that offers a higher yield but also a greater risk to your principal. Ultrashort-bond funds and bank-loan funds are a great example of why you shouldn't chase yield: Although some investors had used funds in both categories as a higher-yielding money market substitute, the average fund in these groups lost 8% and 30%, respectively, in 2008's market shock.

CDs usually offer higher yields than money market funds and other cashlike vehicles, and they offer FDIC protection to boot. The big drawback is that you're locking yourself into a fixed term and rate. Money market mutual funds, bank-offered money market accounts, and high-yield savings accounts offered by online banks and credit unions can all buy new, higher-yielding securities if rates move up.

If you're in a high tax bracket, another option for your cash is a municipal money market fund, whose income will be free of federal income tax. Most fund companies have a tax-equivalent yield function on their bond calculators that can help you determine whether you're better off in a muni or taxable money market fund once the tax effects are factored in.

Day 5: Map out your financial goals

Degree of difficulty: Easy

Most of us have a running list of financial goals: whether it's paying off our homes, financing college for the kids and grandkids, funding a comfortable retirement, or paying for here-and-now creature comforts like vacations and new cars. Few people, however, take time to document their goals and quantify exactly how much they'll cost, even though that step is key to helping you set your household's financial priorities. It's also pretty easy.

Today, take a moment to jot down your goals. Group them into one of three bands: short-term goals (goals you'd like to achieve in five or fewer years), intermediate-term goals (five to 15 years from now), and long-term goals (15 years or more in the future). Once you've done that, prioritize your goals within each time frame. Be sure to include debt retirement on your list of goals.

The next step is to estimate exactly how much those goals will cost you. If your goal is close at hand—such as buying a car next summer—quantifying it is straightforward. But if it's a goal that's further in the future or one that you'll pay for over several years, the calculation may be more complicated and you'll also have to factor in inflation. FinAid's College Cost Projector (www.finaid.org) can help you calculate the cost of college using historic (and historically scary) inflation rates, and Bankrate's Retirement Calculator (www.bankrate.com) shows you how much you'll need to save for retirement. Morningstar.com's Savings Calculator is a multipurpose calculator that helps you see the interplay between your current savings, future contributions, and your expected rate of return.

Day 6: Allocate capital like a pro

Degree of difficulty: Moderate to difficult

Although Morningstar focuses on helping you invest in stocks, funds, and exchange-traded funds, the reality is that investors' highest-impact decisions precede the decision to invest in the market. Do you save enough? And when you have extra cash on hand, do you pay down debt, invest, or do a little of both?

When it comes to the latter decision, it's helpful to think of yourself as a business owner, steering your cash toward the opportunity that is apt to offer you the best return on your capital.

Paying off debt—even more benign types of debt like mortgage debt or student loans—offers you a knowable return on your money—always a good thing. If you're receiving a tax break on your interest, as is the case with mortgage interest and some student loans, you'll get less of a bang out of paying off the note prematurely. But in my experience, many mortgage-holders overestimate the benefits of their tax-deductible interest; later in the life of the mortgage, tax-deductible interest may be a small slice of the overall mortgage payment.

Investing in the market offers a potentially higher rate of return, but the hitch is that return, unlike paying off debt, isn't guaranteed. When forecasting returns for your investments, be conservative. I usually use a 6% rate of return for equities, a 2% return for bonds, and a 1% return for cash. Based on the asset mix of your portfolio, you can then forecast a ballpark return for it. Armed with that information, you can then determine whether investing in the market or paying off debt is the best return on your dough.

Day 7: Invest for mid-term goals
Degree of difficulty: Moderate

Yes, current yields on truly safe investments like CDs and money market funds are shrimpy. But if you're building an emergency fund or saving for a goal that's close at hand, the risks of venturing beyond ultra-safe investments outweigh any extra yield you're able to pick up. It's boring, but you'll need to rely on your own savings, rather than investment returns, to do the heavy lifting in these instances.

But what if you're saving for an intermediate-term goal and don't expect to need the money for another couple of years or even more? In that case, you can tolerate modest fluctuations in the value of your principal. A core intermediate-term bond fund can fit the bill. A few favorites among Morningstar analysts include Dodge & Cox Income (DODIX), Fidelity Total Bond (FTBFX), and Metropolitan West Total Return Bond (MWTRX).

If you have an even longer time horizon—anywhere between five and 10 years—you can hold stocks as well as bonds. Morningstar analysts like Vanguard Wellesley Income (VWINX) and Dodge & Cox Balanced (DODBX), which combine stocks and bonds together. If you hold one of these funds and are getting close to needing money to fund your goal, you can transition the assets to cash for safe-keeping.

Day 8: Identify the right vehicle for college savings
Degree of difficulty: Moderate

As with retirement investments, the college-savings landscape is far more cluttered and complicated than it needs to be, with myriad vehicles competing for investors' attention.

Due to their generous contribution limits and the potential for tax-free withdrawals, section 529 college-savings plans have emerged as the vehicle of choice for families looking to sock away a substantial sum for school. 529s have generally improved substantially over the past few years, with costs coming down and the quality of investment options going up. To see how these college-savings plan compare, consult Morningstar’s annual 529 Plan Ratings (www.morningstar.com/save-for-college.html).

Some investors, however, would like to invest for their kids outside the confines of a dedicated college-savings vehicle like a 529 or Coverdell Education Savings Account. If that's you, you have a couple of different options. Setting up a UGMA/UTMA account is one simple way to go, but the drawbacks probably outweigh the pluses, in my view. The assets become the property of the child once he or she reaches the age of majority (varies by state but usually age 18 or 21), when some young people may not yet be equipped to make good financial decisions. And if you're pretty sure your child is college-bound, you should know that those UGMA/UTMA assets will work against your child in financial aid calculations.

For those reasons, investors looking to save outside of a dedicated college-funding vehicle like a 529 or Coverdell should consider saving for their kids in one of a couple ways. The first would be simply to hold tax-efficient investments, such as low-turnover exchange-traded and index funds, individual non-dividend-paying stocks, municipal bonds/funds, or tax-managed mutual funds, within the confines of the parents' taxable account. Withdrawals won't be tax-free, as is the case with qualified withdrawals from a Coverdell or 529, but it's straightforward and investors gain the added flexibility to use the money outside of college expenses, penalty free, if the need arises.

Another option is to use a Roth IRA to save for your kids. In a Roth, you can pull out your contributions (not your gains), tax-free, at any time and for any reason, making the vehicle a great multi-tasker for those looking to save for retirement and college at once. The key drawbacks? Roth contribution limits are pretty low—currently $5,500 for those under 50 and $6,500 for those over—and pulling money out for your kids leaves less money at work for retirement.

Day 9: Invest your college-savings assets

Degree of difficulty: Moderate

The bear market of 2008 forced many retirees and pre-retirees to recalibrate their plans and, in some cases, to make meaningful reductions in their spending. But it also had a huge impact on another, much younger group: college-bound students. Unfortunately, many college-savings plans, including several professionally run 529s, were far too skewed toward stocks in the later stages of their investment paths coming into 2008, resulting in big savings shortfalls for students getting close to college.

If that experience had a silver lining, though, it was that it underscored the importance of holding on to what you already have versus gunning for big returns in your child's college-savings plan, particularly as college draws near.

Many of the investment pros running 529 college-savings programs have scaled back the equity holdings of their age-based options to make them more conservative, and added index funds in place of poorly chosen actively managed funds, in the hopes of reducing the risk of a big shortfall at the

worst possible time. Investors managing the asset allocations of their own college-savings programs should also take the lessons of 2008 to heart.

Here are a few quick tips:

- By the time your child hits the teenage years, more than 50% of his or her college fund should be in bonds and cash.
- By the time your child is a junior or senior in high school, equities should compose only a small slice (less than 20%) of his or her college dough.

If you have to boost your college savings using a combination of financial aid, student loans, or work-study, it's better than risking the money you have been able to set aside.

Day 11: Check up on the quality of your company retirement plan
Degree of difficulty: Moderate to difficult

If you're earning a match on your 401(k) plan contributions, it's a no-brainer to invest at least enough to earn the match. But what if your company isn't matching, or if you'd like to make a larger contribution to your retirement than you're being matched on? Is it best to stick with the 401(k) or turn to another vehicle like a Roth IRA?

The answer to that question depends, at least in part, on the quality of your plan. To help determine whether your plan is worth investing in or a is a stinker, ask your HR administrator for a document called a Summary Plan Description, which lays out crucial information about your 401(k).

Beware: This document is apt to be crammed with legalese and not likely to be easy reading. But after a little bit of hunting, you should be able to locate your plan's administrative expenses. These fees may be depicted in percentage or dollar terms; if the latter, divide your plan's costs by the total dollars in the plan. If your plan doesn't have any additional administrative costs, that's a good sign. But if it layers on additional administrative fees that amount to 0.50% or more per year, that's a red flag that your plan is a costly one. Check to see whether your plan includes other bells and whistles, such as a brokerage window, which allows you to invest in options outside the plan; the ability to take a loan; and the ability to make Roth 401(k) contributions.

After that, conduct a quick checkup of the breadth and quality of your plan's holdings using the data and Analyst Reports on Morningstar.com. Look for a good array of core-type mutual funds: large-cap U.S. and foreign stock offerings, balanced funds, and core intermediate-term bond funds. For stock funds, look for expense ratios of less (preferably much less) than 1% per year, though specialized funds like international and small-cap offerings may charge a touch more. For bond funds, expense ratios of less than 0.75% are ideal. Read Morningstar's Analyst Reports for a quick checkup on the quality of the options in your plan.

If your plan checks out well on the above measures, funding it up to the maximum allowable level is apt to be a good use of your cash, thanks to the tax-deferred compounding that company-retirement plans afford. Before doing so, however, you should also deploy some of your retirement assets into an IRA. You can start and maintain an IRA with very low to no administrative expenses, and you can also access a broader range of investments than you can when investing inside of a company retirement plan like a 401(k).

Day 12: Maximize your match
Degree of difficulty: Easy

If you're not earning any matching funds on your 401(k), my usual advice is to fund an IRA up to the maximum allowable level first. The reason is that you can put any investment you'd like into an IRA, and you won't have to pay any additional administrative expenses to invest in one, in contrast with many 401(k) plans. IRA investors also enjoy tax breaks that parallel 401(k)s. If you find yourself with additional assets to invest after that, turn to your 401(k) (provided it's a good one!).

If you are lucky enough to earn matching contributions on your 401(k), plan to take advantage of each and every one of those dollars. This is particularly relevant if you're highly compensated and/or you expect to receive a large bonus early in the year. That's because many companies make matching contributions throughout the year, but if you hit your allowable 401(k) contribution well before year-end, you won't be able to take full advantage of any matching contributions your employer would've made in the remainder of the year. (Some companies make an adjustment to help employees receive a match on their full 401(k) contributions regardless of when those contributions were made, but others do not.)

If this is a potential issue for you, you'll need to lower your contribution rate per paycheck to ensure that you don't reach your maximum contribution too early in the year. People who receive large bonuses may be especially vulnerable to missing out on matching contributions; they can usually correct this issue by lowering the percentage of their bonus that goes toward their 401(k).

Day 13: Use an IRA to Improve Your Portfolio
Degree of difficulty: Easy

If you have most of your retirement assets in a company-retirement plan and are using an IRA to supplement what you already have, you can use your IRA in one of two ways.

You can hold core-type investments, which tend to be mainstays in most 401(k) plans: index stock and bond funds, large-cap actively managed funds, balanced funds, and so forth.

Alternatively, you can use your IRA to fill holes in your company retirement plan. For example, say your plan includes adequate stock funds, but its bond funds charge more than 1% per year in annual

expenses—sure to cut into your long-term returns. If that's the case, you can fill your company retirement plan with the decent stock funds and leave the bond portion of your portfolio to an IRA. Morningstar's Instant X-Ray tool (www.morningstar.com) can help you see where you've got holes in your existing asset mix.

You can also use your IRA to include asset types not commonly found in company retirement plans, including funds dedicated to real estate investment trusts, commodities, or Treasury Inflation-Protected Securities. All of these investment types do a good job of diversifying a portfolio that's composed primarily of conventional stocks and bonds. They also can be a headache when held outside of tax-sheltered accounts, because they generate a lot of taxable income. So, they're ideal holdings for an IRA.

Day 14: Manage your portfolio for tax efficiency

Degree of difficulty: Moderate

Although utilizing tax-sheltered vehicles like IRAs and 401(k)s can help you dodge the tax collector, at least temporarily, there are occasions when you'll need to save in your taxable accounts. Perhaps you're socking money away for a goal that's close at hand, for example, or maybe you've maxed out your contributions to the tax-sheltered vehicles available to you.

If that's the case, there are still some steps you can take to reduce the tax effects on these investments.

One of the key steps you can take is to limit your own trading activity, thereby reducing the taxable capital gains you'll owe from year to year. I'm also a big fan of actively pruning your taxable portfolio's losers, which helps you offset capital gains from your winners. Investors who are in the 10% and 15% income tax brackets can do the opposite—pre-emptively selling their long-term gainers and immediately re-buying them. The advantage of that strategy is that it’s tax-free, as those in the 10% and 15% income-tax brackets currently pay a 0% rate on long-term capital gains, and it also increases the investor’s cost basis in her holdings.

Finally, it pays to be careful about what types of investments you hold in your taxable accounts. High-turnover stock funds, whose short-term capital gains are taxed as ordinary income, are a definite "don't," as are high-income-producing investments such as REITs and junk-bond funds.

On the "buy" list for taxable investors are low-turnover exchange-traded funds and index funds, municipal-bond funds, individual stocks, and tax-managed funds.

Day 15: Conduct a "quick and dirty" portfolio checkup

Degree of difficulty: Easy to Moderate

A good starting point for a portfolio checkup is to take a snapshot of where your total portfolio is right now, with an eye toward flagging any notable trouble spots. The best tool for the job is Morningstar's Instant X-Ray tool (www.morningstar.com). Simply plug in tickers for each of your holdings (use CASH$ for cash), then hit "Show Instant X-Ray" for a look at your portfolio's stock/bond/cash mix and breakdown by investment style, sector, and geographic breakdown.

That's a lot of information, and may not be valuable without some context. To help make sense of what you're looking at, click on the "Interpreter" tab under "Edit Holdings." As you do so, run through the following checklist and take notes as you go along:

1. Is your stock/bond/cash mix in line with your targets? Take note if your allocation to any one asset class is more than five or 10 percentage points higher or lower than your targets. If it is, it's time to rebalance.

2. Are you making big, inadvertent sector bets? Compare your weightings to the S&P 500's (provided in X-Ray). Again, look for big bets of five or 10 percentage points or more.

3. How about investment-style bets? To help provide a reference point, the Dow Jones Wilshire 5000 Index, a measure of the broad market, recently had the following breakdown in the Morningstar style box: 25% large value, 25% large blend, 24% large growth, 6% in each of the mid-cap boxes, 3% in small value, 3% in small blend, and 2% in small growth.

4. Is a big share of your portfolio in a single stock? To see, click on the Intersection tab. Positions amounting to 5% or more of your total portfolio can ramp up its risk level.

5. Do you have an adequate emergency fund? Make sure you have a bare minimum of three months' worth of living expenses in a cash or cashlike vehicle. (Don't use X-Ray to gauge your cash holdings because it is likely to overstate them by including cash holdings that appear in long-term mutual funds; you couldn't access that cash without selling the whole fund, so that money isn't really liquid.) If you have extra time, click the individual security names at the bottom of the main X-Ray page to see data and analyses for the stocks, mutual funds, and ETFs in your portfolio.

Day 16: Look for opportunities to streamline

Degree of difficulty: Moderate

Today's task is one that's relevant to investors of all ages and of all life stages: combating portfolio sprawl.

Diversification is a good thing, of course, but you can also overdo it. It requires time and research to keep track of important developments at stocks and funds, and that task is compounded when you have many different accounts. And the more investments you have, the greater the likelihood that your portfolio will behave like the market. There's nothing inherently wrong with market-like performance, but you don't want to have to pay active management fees when an index fund would have done the job just as well.

So what are some strategies for beating back the sprawl? Index mutual funds and exchange-traded funds that track a broad market segment are a good place to start if you're trying to streamline your financial life; Morningstar's mutual fund and exchange-traded fund pick lists include plenty of topnotch core index options.

Alternatively, you could take advantage of all-in-one options, either by using a target-date fund or a stock/bond hybrid fund. And if you're managing multiple accounts geared toward a single goal—for example, you and your spouse each have IRAs and 401(k)s, as well as taxable assets earmarked for retirement—think of them as a single entity rather than running each account as a well-diversified whole. Doing so gives you the freedom to pack a significant share of your assets into the best investments available to you within each account. Use Morningstar's Instant X-Ray tool to make sure the whole portfolio is diversified and that the asset allocation is in line with your target.

Day 17: See if you're on the right track for retirement savings

Degree of difficulty: Moderate

Most of the tasks in my 21-day investment fitness regimen have centered around helping you get your investment program up and running. But once you do, it's essential that you periodically check in to make sure that your portfolio and your savings rate put you on track to help you meet your goals.

One way to gauge whether your retirement plan is on track comes courtesy of Fidelity Investments. The firm recommends that investors in their 30s have retirement savings equal to their current salaries, those in their 40s have saved 3 times their current salaries, those in their 50s have saved 6 times, and those in their 60s have saved 8 times their current salaries.

For investors who are closing in on retirement and want to gauge their portfolio's viability to supply their in-retirement income needs, they can simply multiply their current balances by 0.04. If that amount, plus any predictable income they'll be able to rely on through Social Security and/or a pension, is sufficient to live on, they're likely on the right track. (Retirement researchers have found

that withdrawing 4% of a retirement portfolio's balance in year 1 of retirement, then inflation-adjusting that dollar amount in subsequent years, gives a balanced portfolio a good shot of lasting for 25-30 years.)

Those are just rules of thumb, though. A financial advisor can provide a more precise read on the viability of your investment program, and can help you tweak it based on your own situation. Alternatively—or perhaps in addition to customized financial advice—you can turn to online tools to gauge the sufficiency of your retirement assets. T. Rowe Price's free Retirement Income Calculator (www.troweprice.com) is one of the most comprehensive. You'll be prompted to enter some information about yourself—your birth date, your expected retirement date, your current asset level and allocation, and your desired level of income in retirement. (You won't be asked to provide any personally identifying information, such as your name or Social Security number, though, so don't worry about anyone contacting you with a sales pitch.) The calculator will then give you a gauge of whether your portfolio in its current incarnation will support your desired level of income.

The bottom line with all of these tools is that they help you assess whether your portfolio can realistically support your goals. And the sooner you make that determination, the better positioned you will be to make changes so you don't fall short.

Day 18: Get a plan for your portfolio as you near retirement
Degree of difficulty: Moderate

Amassing enough assets to retire is the heaviest lifting that any of us will do in our investing lives. But even after you've cleared that hurdle, it's still important to have a plan for managing your assets during retirement.

Because encountering a bear market early in your retirement years can have a devastating impact on portfolios that are too aggressively positioned, it's a sensible idea to start moving a portion of your portfolio to safer securities like cash and bonds as retirement draws close.

Another key task for retirees and pre-retirees is to determine a realistic portfolio withdrawal rate. How much can you take out without running the risk of outliving your assets? There aren't any one-size-fits-all answers, but many planning experts agree that a 4% initial withdrawal rate, combined with ongoing adjustments to account for inflation, is sustainable with a 60% equity/40% bond portfolio over a 25-year retirement period. However, retirees with longer time horizons and/or more conservative equity allocations should take more modest withdrawals. It's also a good idea to adjust your withdrawal rate downward if you encounter a weak market; that way, more of your portfolio is in place to recover when stocks do.

Finally, if you've saved for retirement in various accounts—and most of us have—your retirement portfolio strategy must also include a plan for tapping those assets. As a general rule of thumb, you'll want to tap your taxable accounts first, deductible IRAs and company-retirement plan assets second,

How to Sequence Withdrawals in Retirement

1 If you're over age 70 2 your first stop for withdrawals are those accounts that carry required minimum distributions, or RMDs, such as traditional IRAs and company retirement plans. (You'll pay penalties if you don't take these distributions on time.)

2 If you're not required to take RMDs or you've taken your RMDs and still need cash, turn to your taxable assets. Start by selling assets with the highest cost basis first and then move on to those assets where your cost basis is lower (and your tax hit is higher).Relative to tax-deferred or taxfree assets, these assets have the highest costs associated with them while you own them, so it makes sense to deplete those first.

3 Tap your traditional IRA or 401(k) if you need to take withdrawals above and beyond what your RMDs and taxable accounts can provide.

4 Save Roth IRA assets for last.

and Roth assets last. If you're subject to required minimum distributions, fulfilling those distributions comes first.

Day 19: Use a "bucketing" system when constructing your in-retirement portfolio

Degree of difficulty: Moderate to Difficult

One of the most daunting aspects of managing your finances is figuring out how to transition from accumulation mode into retirement, or "harvest" mode.

One intuitive way to construct a retirement portfolio is to create various buckets of money based on when you expect to tap them for living expenses. Bucket number one contains living expenses for the next 1 to 2 years, and therefore should consist of highly liquid investments like CDs and money market funds. This is money you can't afford to lose.
Bucket number two should be positioned for living expenses in years 3 through 10, and therefore you can afford to take on slightly more risk. Intermediate-term bond funds and even conservative stock funds or balanced fund are good choices for the intermediate sleeve of your retirement portfolio.

Those assets you don't expect to tap for at least 10 more years can be stashed in stocks and stock mutual funds. Because you've established you have a fairly long time horizon for this money, you won't be unduly upset if the stock market has periodic hiccups.

Day 20: Make sure your retirement portfolio includes inflation protection

Degree of difficulty: Easy

If you're already retired or getting ready to do so, one of the key risks that you'll need to guard against is inflation. Social Security payments are adjusted for inflation (assuming the Consumer Price Index is going up), but the paychecks you'll take from your retirement portfolio will grow smaller and smaller—in real terms—as the prices on the stuff you buy trend up. It's therefore important to position your portfolio to address that threat.

Although investors often debate the best investments to guard against inflation, with some favoring so-called hard assets like commodities and gold, Treasury Inflation-Protected Securities (TIPS) provide the most direct way to do so. The principal values of TIPS adjust upward to keep up with inflation, as measured by the Consumer Price Index, giving investors a straightforward, low-cost way to ensure that their portfolios keep up with higher prices. I-Bonds, which can be purchased directly from the U.S. Treasury, have similar inflation-defending features. (In contrast with TIPS, however, I-Bonds receive an adjustment to their interest payments to account for inflation.)

Day 21: Schedule regular checkups

Degree of difficulty: Moderate

Investors often make the mistake of checking up on their portfolios too frequently, or worse yet, only after big market moves, when they're most inclined to make rash decisions. To help avoid that pitfall, schedule regular checkups in advance. For most people, one comprehensive portfolio review per year is plenty, and much better than obsessing on a daily basis. Year-end—ideally around Thanksgiving, before the holidays gear up—is a good time to conduct your annual portfolio review, because you can still make adjustments to reduce your tax bill.

Morningstar.com's Portfolio Manager makes it easy to monitor your portfolio on an ongoing basis. You can either enter your portfolio directly into the tool or via our Instant X-Ray tool. After you've viewed the X-Ray for your portfolio, simply click Save Instant X-Ray as a Portfolio.

If you feel information overload setting in, here are some tips to help you focus on the most important factors: Fill in the Investment Policy Statement included here and also follow the steps in my "quick and dirty" portfolio checkup (Day 15).

Simple Investment Policy Statement

WHAT YOU'LL NEED

- Most recent statements for all of your investment accounts
- A snapshot view of your portfolio using Morningstar.com's Portfolio X-Ray

IDENTIFY INVESTING GOALS

Investing goal

When you'll need the money

How long you'll need the money

Estimated amount needed

Current assets

Additional contributions/frequency

SPECIFY ASSET ALLOCATION RANGES

Domestic Equity		**% to**	
Large cap (optional)		% to	
Mid-cap (optional)		% to	
Small cap (optional)		% to	
Foreign Equity		**% to**	
Developed markets (optional)		% to	
Developing markets (optional)		% to	
Bond		**% to**	
Short term (optional)		% to	
Intermediate term (optional)		% to	
Long term (optional)		% to	
Cash		**% to**	

SPECIFY MONITORING/REBALANCING FREQUENCY

- Annually
- Semiannually
- Quarterly

Rebalance when allocations to broad asset classes are ______ % points from targets.

IDENTIFY MONITORING CRITERIA Check all that apply

- Portfolio asset allocation vs. Targets
- Current assets vs. Goal assets
- Other

Develop Your Plan

IRA, 401(k), 529
What's the Best Tax-Sheltered Account Type for You?

Getting the skinny on tax treatment, withdrawals, and permissible investments can help you choose wisely.

By Christine Benz

Congress has periodically looked at the idea of simplifying tax-sheltered savings, but for now investors have to wend their way through a dizzying maze of tax-advantaged investment wrappers: multiple types of IRAs, company-retirement plans, and college-savings accounts, each with its own tax treatment, its own set of rules governing who can contribute and how much, and its own policies on distributions. It's all enough to make you wish for the good old days of certificates of deposit and passbook savings accounts.

But giving due care to the wrapper you choose for your investment accounts and maximizing your investments in tax-sheltered vehicles can greatly enhance your take-home return. The longer your investment horizon, the greater the tax savings are apt to be. Here's an overview of the various types of savings vehicles available for your long-term investing assets—especially retirement—including a summary of the types of individuals who will tend to benefit most from each investment vehicle. Note that there's not a single best investment wrapper for any one individual; most savers will hold a combination of these account types during their lifetimes. M

Traditional 401(k), 403(b), and 457 Plans

Geared Toward	Retirement saving
Tax Treatment	Pretax contributions; all withdrawals taxed as ordinary income
Tax Benefit	Tax-deferred compounding
Contribution Limit	$18,000 (under age 50)/$24,000 (over 50) in 2016
Income Limit	None
Withdrawal Flexibility	Limited. Individuals must pay taxes and a 10% early-withdrawal penalty prior to retirement age unless they meet certain exceptions.
Investment Flexibility	Limited. Employees must typically choose from fixed menus of investment options.
Required Distributions	Yes, at age 70 1/2 unless still working
Pros	Making pretax contributions provides instant gratification; contributing fixed sums at regular intervals ensures discipline; employers may offer matching contributions; plans may provide access to low-expense institutional share classes.
Cons	Choices may be limited and subpar; small plans often feature high administrative costs and/or high-expense investment options.
Best For	Savers who will benefit from built-in discipline and ease of use.

Roth 401(k), 403(b) and 457 Plans

Geared Toward	Retirement saving
Tax Treatment	Aftertax contributions; qualified withdrawals tax-free
Tax Benefit	Tax-free compounding; tax-free withdrawals
Contribution Limit	$18,000 (under 50); $24,000 (over 50) in 2016
Income Limit	None
Withdrawal Flexibility	Limited. Individuals must pay taxes and a 10% early-withdrawal penalty prior to retirement age unless they meet certain exceptions.
Investment Flexibility	Limited. Employees must typically choose from fixed menus of investment options.
Required Distributions	Yes, at age 70 1/2, though rolling over proceeds to a Roth IRA can help circumvent required minimum distributions, at least for the time being. (A proposal in President Obama's budget for fiscal year 2017 included a provision to subject Roth IRAs to RMDs.)
Pros	Ability to take tax-free retirement withdrawals; contributing fixed sums at regular intervals ensures discipline; plan may have access to low-expense institutional share classes.
Cons	Choices may be limited and subpar; small plans often feature high administrative costs and/or high-expense investment options.
Best For	Individuals who expect to be in a high tax bracket in retirement or those who aren't sure about future tax benefits but already have substantial assets in Traditional IRAs and 401(k)s.

Traditional IRA (Deductible)

Geared Toward	Retirement saving
Tax Treatment	Contributions are deductible on income-tax return, provided income is below limit; all withdrawals taxed as ordinary income
Tax Benefit	Deductible contributions; tax-deferred compounding
Contribution Limit	$5,500 (under 50); $6,500 (over 50) in 2016
Income Limit	Single filers with modified adjusted gross incomes below $71,000 who are covered by a retirement plan at work can make at least a partially deductible contribution for the 2016 tax year. In 2016, married couples filing jointly who are covered by a retirement plan at work can make at least a partially deductible contribution if their modified adjusted gross incomes are less than $118,000.
Withdrawal Flexibility	Limited. Individuals must pay taxes and a 10% early withdrawal penalty prior to retirement age, except in certain cases.
Investment Flexibility	High. Most investment types can be held inside an IRA, with a few exceptions.

Required Distributions	Yes, at age 70 1/2
Pros	Investors can choose low-cost and best-of-breed investments with limited administrative costs.
Cons	No so-called guardrails on investment choices, unlike 401(k)s; RMDs plus ordinary income tax due on in-retirement distributions can ratchet up in-retirement tax costs.
Best For	People who think their tax bracket today is higher than it is likely to be in retirement.

Traditional IRA (Nondeductible)

Geared Toward	Retirement saving
Tax Treatment	Aftertax contributions; withdrawals of investment earnings taxable at ordinary income tax rate
Tax Benefit	Tax-deferred compounding
Contribution Limit	$5,500 (under 50); $6,500 (over 50) in 2016
Income Limit	None
Withdrawal Flexibility	Medium. Individuals can withdraw nondeductible (that is, aftertax) contributions at any time without taxes or penalty, but early withdrawals of investment earnings will trigger both tax and a penalty. (You can avoid the penalty if your situation fits with one of the exceptions.)
Investment Flexibility	High. Most investment types can be held inside an IRA, with a few exceptions.
Required Distributions	Yes, at age 70 1/2
Pros	Investors can choose low-cost and best-of-breed investments with limited administrative costs; nondeductible IRA can provide an entry point to a Roth IRA via the "backdoor," which entails making a nondeductible Traditional IRA contribution and then converting those assets. (A proposal in President Obama’s budget for fiscal year 2017 would put a stop to the backdoor Roth IRA, however.) May be a decent investment wrapper for investors who want to shelter income-producing assets.
Cons	Investing in a tax-savvy manner in a taxable account will tend to offer better long-term tax treatment: Long-term gains from a taxable account are taxed at the investor's lower capital gains rates, whereas withdrawals of investment earnings from a Traditional nondeductible IRA are taxed as ordinary income.
Best For	Individuals who cannot contribute directly to a Roth IRA or Traditional deductible IRA.

Roth IRA

Geared Toward:	Retirement saving
Tax Treatment:	Aftertax contributions; tax-free withdrawals in retirement.
Tax Benefit:	Tax-free compounding and withdrawals.
Contribution Limit:	$5,500 (under 50); $6,500 (over 50) in 2016
Income Limit:	Single filers with modified adjusted gross incomes below $132,000 can make at least a partial contribution for 2016. Married couples filing jointly can make at least a partial contribution if their modified adjusted gross incomes are less than $194,000.
Withdrawal Flexibility:	Medium. Individuals can withdraw their contributions at any time without taxes or penalty, but early withdrawals of investment earnings may trigger tax and the 10% early-withdrawal penalty. (You can avoid the penalty if your situation fits with one of the exceptions.)
Investment Flexibility:	High. Most investment types can be held inside an IRA, with a few exceptions.
Required Distributions:	No
Pros:	Investors can choose low-cost and best-of-breed investments with limited administrative costs; ability to take tax-free withdrawals in retirement reduces in-retirement tax costs; Roth IRAs are among the most tax-friendly for heirs to inherit.
Cons:	No guardrails on investment choices; individuals whose tax brackets go down during retirement may have been better off taking the tax break upfront by contributing to a Traditional deductible IRA or Traditional 401(k).
Best For:	Individuals who expect to be in a high tax bracket in retirement or those who aren't sure about future tax benefits but already have substantial assets in Traditional IRAs and 401(k)s.

529 College-Savings Plan

Geared Toward	College savings
Tax Treatment	Contributions may receive a state tax break (either a deduction or a credit). Money compounds on a tax-free basis and withdrawals to pay for qualified college expenses are tax-free, too.
Tax Benefit:	State tax break; tax-free compounding; tax-free withdrawals.
Contribution Limit:	Per IRS guidelines, contributions cannot exceed amount necessary to provide education for beneficiary. Deduction amounts vary by state, and gift tax may apply to very high contribution amounts.
Income Limit:	None

Withdrawal Flexibility:	Medium. Investors can withdraw contributions at any time without taxes or penalty. Withdrawals of investment earnings must be used for qualified college expenditures or will incur taxes and a 10% penalty. Those withdrawing funds for noncollege expenses may also be required to pay back any state tax deduction they've received on contributions. They can, however, change the beneficiary of a plan, as long as the new beneficiary is a family member of the former beneficiary.
Investment Flexibility:	Low. Investors in 529 plans must choose their investments from a preset menu offered by the plan.
Required Distributions:	None.
Pros:	High allowable contribution amounts, state tax breaks on contributions, and tax-free compounding and withdrawals. The plans reduce the financial-aid impact compared with money held in the student's name.
Cons:	States may impose an extra layer of administrative costs, and investment choices may be costly and/or subpar.
Best For:	Individuals who are aiming to stash a significant sum for college while also enjoying tax benefits.

Coverdell Education Savings Account

Geared Toward:	Educational savings, including elementary school, high school, or college.
Tax Treatment:	Money compounds on a tax-free basis, and withdrawals to pay for qualified educational expenses are tax-free, too.
Tax Benefit:	Tax-free compounding; tax-free withdrawals for qualified educational expenses.
Contribution Limit:	$2,000 per beneficiary per year.
Income Limit:	Single income tax filers with modified adjusted gross incomes of more than $110,000 and married couples filing jointly with incomes greater than $220,000 cannot make contributions to a Coverdell.
Withdrawal Flexibility:	Medium. Withdrawals of contributions are tax- and penalty-free. And in contrast with 529 assets, in which withdrawals will incur taxes and a penalty unless used for qualified college expenses, Coverdell assets may be used for elementary and high school expenses, too. You can also change the beneficiary of a plan, as long as the new beneficiary is a family member of the former beneficiary.
Investment Flexibility:	Medium. Coverdell ESA investors can, in theory, invest in a broad swath of assets, but not all investment providers offer the accounts.

Required Distributions:	Funds must generally be distributed from an account by the time the student reaches age 30, though they may be rolled over into a Coverdell ESA for another eligible family member.
Pros:	Ability to use funds for elementary and high school expenses; flexibility to invest in a broad variety of securities, including mutual funds and individual stocks.
Cons:	Limited contribution amounts; investment providers may not offer this account type.
Best For:	Individuals aiming to invest relatively small sums for education—including elementary, high school, and college—who are seeking more investment flexibility than 529s afford.

FAQs on 401(k)s

The skinny on Roth versus traditional contributions, early withdrawals, loans, and more.

By Christine Benz

What are the main benefits of investing in a 401(k) versus investing on my own?
For starters, your employer will likely match at least a portion of your contributions—that is, contribute company money on your behalf, as long as you are contributing some of your own money to the account. Try getting your employer to match you on contributions to your bank account!

There are also tax-related benefits. If you contribute to a traditional 401(k), you'll make pretax contributions, and you won't have to pay any taxes on the account as the money grows. You'll pay taxes at your ordinary income-tax rate when you begin withdrawing the money, and you'll also be required to begin withdrawing the money on a set schedule (required minimum distributions) once you're age 70 1/2. If you contribute to a Roth 401(k), you'll contribute dollars that have already been taxed, but you'll enjoy tax-free compounding and tax-free withdrawals on your money in retirement.

By contrast, if you contribute to a taxable account on your own, you'll only be able to contribute aftertax dollars, you'll owe capital gains and income tax on any distributions during your holding period, and you'll pay capital gains on any price appreciation when you sell.

Additional benefits of investing in a 401(k) plan include the ability to automate your contributions as well as the fact that you may be able to gain access to ultra-cheap institutional fund shares that aren't available to you as an individual investor.

How much can I contribute to a 401(k)? Are there income limits on contributions?
Savers under age 50 can contribute $18,000 to a 401(k) in 2016; those over 50 may contribute $24,000 this year. (You can start making those extra catch-up contributions on Jan. 1 of the year you turn 50; you don't have to wait until your birthday.) The contribution limits are the same regardless of whether you contribute to a Roth or traditional 401(k). In contrast with IRAs, there are no income limits on contributions to 401(k)s.

If I trade securities in my 401(k) plan prior to retirement, is my 401(k) provider or the IRS keeping track of the capital gains I'm realizing, and will I get socked with a big capital gains bill in retirement?
No. If you're contributing to a traditional 401(k), all of your withdrawals will be taxed at your ordinary income tax rate, regardless of whether the withdrawal consists of contributed money

or investment appreciation. So even though we wouldn't advise it, you can buy and sell securities all day long inside your 401(k) and you won't have a direct impact on your ultimate tax bill.

My company has a Roth and traditional 401(k) option. How can I figure out which account type is right for me?

Your analysis should hinge on your assessment of whether your tax rate today is likely to be higher or lower than it will be in the future. If you think it will go higher, either because you expect taxes at large to go up or because you think your personal income situation will get much better, you're better off making Roth contributions. If you haven't saved much and retirement is close at hand, you're probably better off making traditional 401(k) contributions, because your tax rate in retirement is likely to be lower than it is today. And what if you have no idea? In that case, it makes sense to split your contributions across both types of account or, if you already have substantial assets in a traditional 401(k) or IRA, to direct new contributions to your Roth 401(k) to help diversify the tax treatment of your 401(k) dollars. If you think your tax bracket in the future will stay the same as it is today, the tax effects will be the same whether you invest in a Roth or traditional 401(k).

At what age can I begin withdrawing my money?

The standard age for penalty-free withdrawals from both IRAs and 401(k)s is 59 1/2. But early retirees have a bit more latitude to tap their 401(k)s than they do IRAs. If they've left their employers at age 55 or later and keep their money in the old 401(k), they can take penalty-free withdrawals from the plan, though they'll still owe tax on those distributions. They do not have the same latitude if they've rolled the money over to an IRA; there they'll owe the 10% penalty on withdrawals prior to age 59 1/2. So-called 72(t) distributions also allow 401(k) and IRA investors under age 59 1/2 to circumvent the 10% early-distribution penalty, but they'll have to take out their money as a series of "substantially equal distributions" for a period of five years or until they turn age 59 1/2, whichever is longer.

What if I need to get my money out before I'm retired? Is that allowed?

Generally speaking, you can't take a distribution from a 401(k) plan while you're still working and under age 59 1/2 unless your situation counts as a hardship withdrawal—for example, if you need to pay medical bills or for higher education costs—and your plan allows for such distributions. You'll pay ordinary income tax and a 10% penalty on the money, but the 10% penalty is waived in very specific situations—for example, if you're disabled or you have medical bills that exceed 10% of your adjusted gross income.

If you've left your employer, you also have latitude to pull your money out of your former employer's 401(k) at that time—you won't have to demonstrate hardship circumstances. However, you will have to pay taxes and a 10% penalty on those withdrawals unless you roll that money into an IRA or your new employer's 401(k); you'll also starve your nest egg of long-term appreciation potential.

Some of my colleagues have borrowed money from their 401(k)s. What are the drawbacks, and how does a 401(k) loan stack up to other sources of emergency funding?

Tapping any sort of retirement account should be way down in the queue if you need funds for emergency expenses; exhaust emergency cash and any taxable investments first. That said, a 401(k) loan is more attractive than some other sources of emergency funding, in part because you pay interest back to yourself rather than a third party. That stands in contrast to tapping a home equity line of credit or using credit cards to cover your short-term cash needs. You can generally borrow up to 50% of your vested account balance or $50,000 from your plan, whichever is less, and the loan must be paid back in five years or fewer, unless the loan was for a primary residence.

But borrowing from a 401(k) doesn't come without risks. The big one is that if you lose or otherwise leave your job, you'll have to pay the money back, or the amount of the remaining balance will count as an early distribution and be subject to ordinary income taxes and a 10% penalty.

401(k) Investors: Avoid These 20 Mistakes

While company retirement plans often have guardrails, investors can goof with contributions, investment selections, loans, and withdrawals.

By Christine Benz

A company retirement plan—whether a 401(k), 403(b), or 457 plan—is the starter savings vehicle for many investors, so it's probably not surprising that the plans usually have more guardrails than other investment vehicles.

Company-retirement-plan menus typically feature plain-vanilla stock and bond funds to keep plan participants from gorging on exotic investment choices, and participants are often opted into age-appropriate target-date fund vehicles. And because 401(k) participants are often extremely hands-off, many plans offer features such as automatic escalation to increase contributions as participants' salaries grow.

Yet, not all plans include such safety features, and 401(k) menus aren't universally high quality. Plans offered by small employers may be larded with extra administrative fees or high-cost funds, and their lineups may skimp on core asset classes such as international equity or fixed income. Participants can also run into unforced errors—for example, not paying enough attention to asset allocation when making their investment selections, or cashing out their money when they change jobs.

In short, 401(k) plans invite the potential for plenty of goofs. Here are 20 common ones, as well as tips on avoiding those mistakes. (Note that in the interest of brevity, I'll use "401(k)" as a shorthand for all company retirement plans throughout this article, but the points generally apply to 403(b)s and 457 plans as well.)

1. **Not Considering Asset Allocation Before Making Investment Choices**
When making investment selections, 401(k) participants are typically confronted with a menu of individual fund choices. The importance of setting an age- and situation-appropriate stock/bond mix never even comes up, even though that will be the biggest determinant of how the portfolio behaves. Setting an appropriate asset-allocation mix is more art than science, but target-date funds or benchmarks like Morningstar's Lifetime Allocation Indexes can be a good starting point.

2. **Not Investing Differently If Your Situation Is an Outlier**
Target-date funds are often the default options in 401(k) plans, and they're valuable in that they can help investors set their asset allocations and monitor them on an ongoing basis. Even investors who don't intend to invest in a target-date fund can use them to help determine an age-appropriate investment mix. That said, the allocations embedded in target-date funds

won't be right for everyone, especially for people with substantial "assets" outside their 401(k) plans. For example, individuals who will be able to rely on pensions to cover most of their in-retirement expenses will likely want a more aggressive asset allocation than would be the case for generic target-date funds. (For this reason, some employers use custom target-date funds, tailored to the situations of their plan participants.)

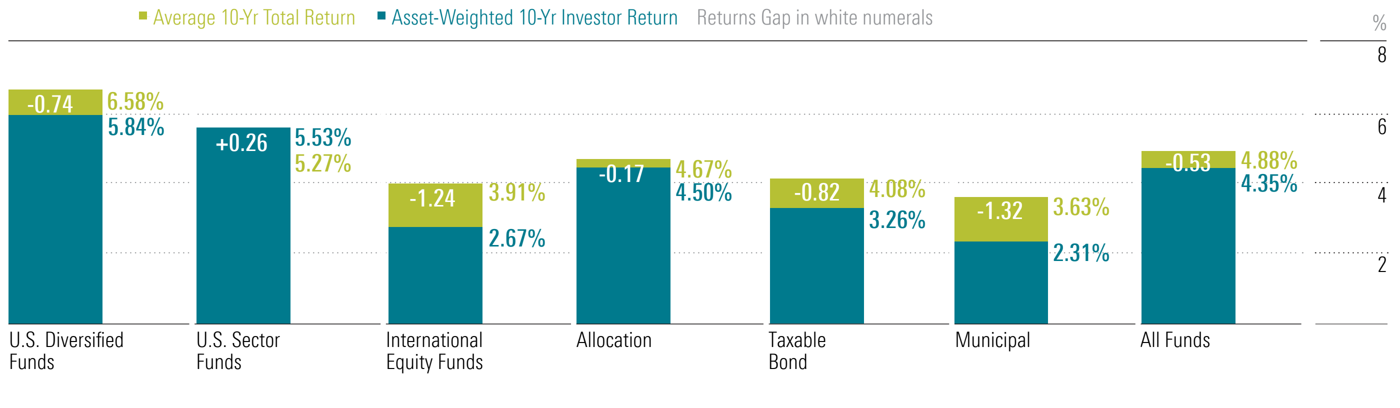
3. **Not Factoring in Other Assets When Making Investment Selections**
For investors who have been working and investing for a while—or those with spouses who hold their own investment accounts—their 401(k) plans may be but a small piece of their overall assets. In that case, it's wise to factor in all of the retirement assets when determining how to allocate the 401(k). Morningstar.com's X-Ray function (www.morningstar.com) can help investors see the composition of their total portfolios across accounts; they can then use their 401(k) plan assets to help steer the total portfolio toward their desired asset-allocation mix.

4. **Focusing Too Much on Past Returns When Making Investment Choices**
In addition to not getting much coaching on their asset allocations, many 401(k) participants are given a limited amount of information about the investment choices on their plans' menus. They may see a fund's asset class or category, as well as its returns over a certain time period, such as the past five years. Is it any wonder so many novice investors simply reach for the funds with the highest numbers? Of course, that's not a recipe for great investment results, as those high performers often fall back to earth. Rather than chasing the hottest performers, investors are better off focusing on fundamental information about funds' strategies, management, and expenses to help populate their asset-allocation mixes. Morningstar's qualitative Analyst Ratings, available on Morningstar.com, attempt to pull all of these considerations together into a single forward-looking measure.

5. **Venturing Into the Brokerage Window Without Paying Attention to Transaction Costs**
If investors do their homework on the fund options on their 401(k) menu and find them wanting, the ability to invest via a brokerage window might appear to be a godsend. Such windows typically give participants many more choices than they have on the preset menu, including the ability to invest in individual stocks and exchange-traded funds. The big downside, however, is that participants will typically incur transaction costs to buy and sell securities within the brokerage window. Those trading costs can drag on returns, especially for investors who are making frequent small purchases.

6. **Avoiding No-Name Funds**
Company-retirement-plan menus are often populated with funds from the big shops—Vanguard, Fidelity, T. Rowe Price, and American Funds. But plans may also include less-familiar names, often collective investment trusts that are explicitly managed for retirement plans. Although information may be less widely available on some of these options than is the case for conventional mutual funds, their expenses may be low and their quality may be good.

Mind the Gap By trading in and out of funds at the wrong times, investors' take-home returns are consistently worse than funds' published total returns. (Trailing Through 12/31/2015)



7. **Overdosing on Company Stock**

   In 2014, the average 401(k) plan participant has more than 7% of his portfolio in stock of his employer, according to information from the Investment Company Institute. That's not a scary number in and of itself, but many participants obviously have much higher stakes and some have none. Even if an employer doesn't run into Enron-style problems, employees with a lot of company stock have too much of their economic wherewithal riding on their employer's performance: their own jobs, plus their portfolio's performance as well. As Morningstar research has indicated, most investors are better off limiting their positions in company stock, though there may be a few mitigating situations in which to hang on to it.

8. **Not Taking Full Advantage of the Tax-Advantaged Wrapper**

   One of the big advantages of a 401(k) plan is tax-deferred compounding: Even if an investment is kicking off heavy income or capital gains distributions, the 401(k) investor won't owe any taxes until he or she begins pulling money from the plan. For that reason, it's wise to stash those investments with heavy year-to-year tax costs inside a 401(k) or IRA. That includes funds that invest in high-yield bonds and Treasury Inflation-Protected Securities, REITs, and high-turnover equity funds. That said, investors needn't go out of their way to add high-tax-cost investments if they don't make sense for them from an investment standpoint. Most young investors have little need for bonds within their 401(k) plans, for example.

9. **Trading Too Frequently**

   The tax-deferred nature of a 401(k)—combined with the fact that 401(k) investors don't typically incur sales charges to buy and sell shares of funds on the plan's preset menu—can be an invitation to trade frequently or to employ tactical, market-timing strategies. But Morningstar Investor Returns data casts doubt on whether investors can add value with frequent trading; investors in target-date funds, because they often buy and then sit tight, often garner better outcomes than investors venturing into and out of individual categories.

10. **Sticking With Default Contribution Rate**
    In the interest of encouraging more employees to participate, many employers are now automatically enrolling their employees in the 401(k); employees need to actively opt out if they don't want to take part. The early results of these efforts show that many employees who are automatically enrolled do, in fact, stick with the plan—a positive outcome. However, employees who stick with the default contribution rate after they've been automatically enrolled—the average is 3.4%—may not earn their full employer matching contribution, if it's a generous one. Moreover, a 3.4% savings rate—assuming the employee isn't also saving outside the 401(k) plan and/or doesn't have a very high salary—is far below any reasonable retirement-savings target.

11. **Not Taking Advantage of Other Automatic Features**
    In recognition of the fact that initial default contribution rates may be insufficient, some plans also opt their employees into "auto-escalation"—nudging up their contributions as the years go by. For other plans, automatic escalation is voluntary. Taking advantage of this option can be a painless way for employees to save more of their salaries, particularly if their contributions increase at the same time they receive raises. Automatic rebalancing can also help hands-off investors by regularly restoring their portfolios back to their target-allocation mixes; while investors themselves may not be inclined to trim their winners or add to stocks when they're in the dumps, as rebalancing requires them to do, automatic rebalancing helps ensure disciplined portfolio maintenance.

12. **Not Keeping Up With Increased Contribution Limits**
    Company-retirement-plan participants who have been maxing out their contributions for many years may forget that the definition of "maxing out" is a moving target. The maximum allowable contribution for savers under 50 was $10,500 back in 2000, but today it's up to $18,000. In addition, investors over age 50 can begin making additional catch-up contributions on Jan. 1 of the year in which they turn 50; for 2016, investors over 50 can contribute a full $24,000 to their 401(k)s.

13. **Maxing Out a Lousy Plan**
    Maxing out a 401(k) plan isn't always a worthy goal, however. If an investor's 401(k) plan features high costs and/or subpar investment options, he or she is usually better off investing just enough in the 401(k) plan to earn any employer matching contributions, then investing any additional retirement assets in an IRA. Investing inside an IRA doesn't typically entail additional administrative expenses, and investors can also populate their IRAs with low-cost, high-quality investment options. The investor with a lousy 401(k) may then choose to invest any additional monies inside the 401(k), but IRA contributions should come first.

14. **Ignoring the Roth Option**
    Many investors came of age when a Traditional 401(k) plan—pretax contributions going in, taxable distributions on the way out—was the only game in town. Today, however, more and more 401(k) plans are allowing participants to make Roth 401(k) contributions instead of—or

in addition to—traditional contributions. Roth contributions consist of aftertax money, but there are no taxes as the money compounds in the account or when it is withdrawn during retirement. Because young investors are often paying taxes at a lower rate than they are apt to be when they retire, Roth contributions can make a lot of sense for early accumulators. And for investors who have been accumulating Traditional 401(k) assets for many years, directing new contributions to the Roth option can provide them with tax diversification that's valuable in retirement.

15. **Not Paying Enough Attention to Beneficiary Designations**
Many investors don't put a lot of thought into their beneficiary designations. Young investors may choose a parent or sibling as the beneficiary of their accounts, for example, and then fail to update their beneficiaries after they've married or drafted other estate-planning documents. Once you set beneficiary designations, keep them up to date.

16. **Letting Orphan 401(k)s Pile Up**
We're a nation of job changers, so it's probably not surprising that many people have multiple small 401(k)s left over from previous employers. The downside is that very small 401(k) accounts may be sent packing. And even investors who have larger sums at work in former employer's plans may suffer from portfolio sprawl. Holding many small accounts can make it difficult to assess the total portfolio's asset allocation and can also present an oversight challenge.

17. **Assuming a Rollover to an IRA Is Always the Best Course**
While rolling 401(k) assets into an IRA can lower overall costs and provide entry to a broad range of investment options, it's not the right option in every situation. If you highly value the investment options inside the plan or benefit from its creditor protections, you may have good reason to stay put inside the confines of a 401(k).

18. **Borrowing Against It**
Going purely by the numbers, taking a loan from a 401(k) trumps other types of financing, such as credit cards or even a home equity line of credit. That's because the 401(k) borrower has to pay interest on the loan back into the account, not to a bank, helping to offset the opportunity cost of not having that money invested. Yet, 401(k) loans carry a big drawback, in that in the event of job loss, the money must be paid back within a fairly short window of time.

19. **Taking Out the Money When You Change Jobs**
For investors who are between jobs, raiding a 401(k) may beckon as a tantalizing way to free up a good chunk of change to cover living expenses or pay off debt. But the costs of doing so are high: In addition to ordinary income tax, early nonqualified withdrawals are subject to an additional 10% penalty. Thus, prematurely raiding a 401(k) should only be considered as a last resort, well behind options like pulling from a Roth IRA, which allows for tax- and penalty-free withdrawals of contributions.

20. **Not Rolling a Roth 401(k) Into a Roth IRA to Avoid RMDs**
    In contrast with Roth IRAs, which aren't subject to required minimum distributions, Roth 401(k)s are subject to RMDs post-age 70 1/2. While there may be a few instances when it makes sense to stay put in a Roth 401(k) and put up with the RMDs, in most cases a rollover to a Roth IRA—before RMDs from the Roth 401(k) commence—is the better course of action. Not only can the money in the Roth IRA continue to grow on a tax-free basis, but the investor can consolidate the 401(k) assets into a single account for easier oversight in retirement. (Note that President Obama's budget proposal, released in mid-February 2016, included a provision to make Roth IRAs subject to RMDs, but for now they are not.) M

Develop Your Plan

Find the Right Stock/Bond Mix

By Christine Benz

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Are you a stock or bond?

You may not be accustomed to comparing yourself to a financial security, but it may be useful when you're trying to figure out your portfolio's optimal stock/bond mix.

The thinking goes like this: If your own earnings power—which investment researchers calls "human capital"—is very stable and predictable, then you're like a bond. Think of a tenured college professor, whose income is secure for the rest of his life, or a senior who's drawing upon a pension from a financially stable company. Because such an individual has a predictable income, he could keep a larger share of his portfolio in stocks than someone with less stable human capital. He's a bond.

At the opposite end of the spectrum would be an investment broker whose income depends completely upon the stock market. When the market is going up and the broker's clients are clamoring to invest, her commissions are high and she may also earn a bonus. But when the market is down, so is her income, and her bonus may be nonexistent. She's a stock. She'd want to hold much more in bonds than stocks, because her earnings are so dependent on the stock market.

Just as our career paths affect how we view our own human capital, so do our ages. When you're young and in the accumulation phase, you're long on human capital and short on financial capital—meaning that you have many working years ahead of you but you haven't yet amassed much in financial assets. Because you can expect a steady income stream from work, you can afford to take more risk by holding equities. As you approach retirement, however, you need to find ways to supplant the income that you earned while working. As a result, you'll want to shift your financial assets away from equities and into income-producing assets such as bonds, dividend-paying stocks, and income annuities.

Of course, there are no guarantees that stocks will return more than bonds, even though they have done so during very long periods of time. Over shorter time periods, stocks can certainly suffer, and even over periods as long as 10 years, stocks can trail bonds. For instance, from February 2002 through February 2012, U.S. stocks gained less than 5.0% per year, on average, whereas high-quality U.S. bonds gained an average of 5.5% per year and endured much less volatility. Against a backdrop like that, it might be tempting to ignore stocks altogether.

At the same time, however, it stands to reason that during very long periods of time, various asset classes will generate returns that compensate investors for their risks. Because investors in stocks shoulder more risk than bondholders, and bondholders take on more risk than investors in ultra-safe investments such as certificates of deposit, you can reasonably expect stocks to beat bonds and bonds to beat CDs and other "cash"-type investments during very long periods of time. In turn, that suggests that younger investors with long time frames should have the majority of their investments in stocks, whereas those who are close to needing their money should have the bulk of their assets in safer investments such as bonds and CDs. During the 10-year period through January 2016, stocks, bonds, and cash have settled into a more familiar pattern, with stocks outpacing bonds by 2 percentage points on an annualized basis, and both stocks and bonds leaving cash in the dust.

What I've discussed so far is called strategic asset allocation—meaning that you arrive at a sensible stock/bond/cash mix and then gradually shift more of your portfolio into bonds and cash as you get older. Of course, it would be ideal if we could all position our portfolios to capture stocks' returns when they're going up and then move into safe investments right before stocks go down. In reality, however, timing the market by, say, selling stocks today and then buying them back at a later date is impossible to pull off with any degree of accuracy—so much so that most professional investors don't try it.

Maintaining a fairly stable asset allocation has a couple of other big benefits: It keeps your portfolio diversified, thereby reducing its ups and downs, and it also keeps you from getting whipped around by the market's day-to-day gyrations. An asset-allocation plan provides your portfolio with its own true north. If your portfolio's allocations veer meaningfully from your targets, then and only then should you make big changes.

To find the right stock/bond mix, you'll need:

- A list of your current investments
- An estimate of the year in which you plan to retire.
- Morningstar.com's Instant X-Ray tool

Step 1

Before determining a target asset allocation, start by checking out where you are now. Log on to Morningstar's Instant X-Ray tool. Enter each of your holdings, as well as the amount that you hold in each. (Don't include any assets you have earmarked for short-term needs, such as your emergency fund.) Then click Show Instant X-Ray. You'll be able to see your allocations to stocks (both domestic and international), bonds, cash, and "other" (usually securities such as convertibles and preferred stock), as well as your sector and investment-style positioning.

Step 2

The next step is to get some guidance on where you should be. Find the asset allocation in the table that corresponds to your anticipated retirement date. Remember, this allocation

corresponds to your long-term goals (for example, retirement assets), not your emergency fund or any shorter-term savings that you've earmarked for purchases that are close at hand.

Morningstar Lifetime Allocation Indexes: Asset Mixes

Use these indexes to help guide your portfolio's asset allocation. Find the year closest to when you expect to retire and look for the allocation that aligns with your risk capacity.

	Target Retirement Year												
Allocations	2060	2055	2050	2045	2040	2035	2030	2025	2020	2015	2010	2005	2000
Aggressive													
Stock %	94	94	94	94	94	91	85	76	67	58	52	47	44
Bond %	3	3	3	3	3	5	10	17	23	28	30	31	30
Inflation Hedge %	3	3	3	3	3	3	4	6	8	11	14	17	20
Cash %	0	0	0	0	0	0	0	1	2	3	4	5	6
Moderate													
Stock %	90	90	90	89	86	79	69	58	49	43	38	35	33
Bond %	7	7	7	8	10	16	24	31	36	39	39	38	37
Inflation Hedge %	3	3	3	3	3	4	6	8	11	14	18	21	23
Cash %	0	0	0	0	0	0	1	2	3	4	5	6	7
Conservative													
Stock %	83	83	81	77	70	59	48	39	33	28	24	22	21
Bond %	15	15	17	21	27	35	43	48	49	50	49	47	45
Inflation Hedge %	2	2	2	2	3	5	7	10	13	17	20	24	26
Cash %	0	0	0	0	0	1	2	3	4	5	6	8	9

Data as of 6/30/16. Inflation hedges include inflation-protected bonds and commodities. Figures may not add up to 100% due to rounding.

Step 3

The allocations offered here are a good starting point, but you can further fine-tune your asset allocation by asking yourself the following questions:

1. Are you expecting other sources of income during retirement, such as a pension?
Yes: More equities
No: Fewer equities

2. Are you expecting to need a fairly high level of income during retirement?
Yes: More equities
No: Fewer equities

3. Have you already accumulated a large nest egg?
Yes: More equities
No: Fewer equities

4. If still working, are you in a very stable career with little chance of income disruption?
Yes: More equities
No: Fewer equities

5. Is there a chance that you'll need to tap your assets for some other goal prior to retirement?
Yes: More equities
No: Fewer equities

6. Do you want to leave assets behind for your children or other loved ones?
Yes: More equities
No: Fewer equities

7. Is your savings rate high?
Yes: More equities
No: Fewer equities

Section 2
Choose the Right Investments

3 Key Questions to Ask When Investing in U.S. Equities

Answering these questions can help you build a U.S. equity portfolio you can live with for many years.

By Christine Benz

Morningstar's data, analysis, and tools can help you identify stocks, mutual funds, and exchange-traded funds that have a good shot at outperforming their peers over time. But finding the "right" investments requires some introspection, too. How much ongoing oversight are you willing to provide for your holdings? Do you get rattled when the market goes down? Are you compelled by data showing that the typical fund manager doesn’t beat the market, or do you believe that a well-chosen basket of individual stocks or actively managed funds has the potential to earn market-beating returns? Answering those questions can go a long way toward helping you identify investments that you can live with for many years.

If you're aiming to fill out the U.S. stock portion of your portfolio, carefully consider the following choices.

Choice 1: Will you invest in individual stocks or funds?

As an investor in U.S. stocks, your first decision is whether you'll buy individual stocks or some type of a managed product—a mutual fund, index fund, or exchange-traded fund—that invests in U.S. stocks. Note that many investors successfully do both; it's not uncommon for individuals to invest the bulk of their portfolios in funds while reserving a smaller portfolio for investing in individual equities. If you decide to do that, just be sure to size up your portfolio's concentrations in individual equities by using the Stock Intersection feature of Morningstar.com’s X-Ray tool. Here are the pros and cons of investing in individual stocks and mutual funds.

Individual Stocks

Why: The ability to generate strong, even market-beating returns is the key reason to consider investing in individual stocks. By concentrating your investments in companies that you've researched thoroughly and determined to have strong fundamentals, you have the opportunity to out-earn the return you'd earn in a mutual fund with a more diffuse portfolio. Individual stock investors can also avoid the management fees that accompany mutual funds and ETFs and exert greater control over their tax costs to boot.

Why not: Because their portfolios are apt to be less diversified, individual-stock investors may have to deal with higher volatility than mutual fund investors. Selecting and monitoring individual stocks also requires more initial research and ongoing oversight than buying and

holding mutual funds. And while investors in individual equities can avoid fund-management fees, they will have to pay transaction costs to buy and sell, which can cut into their returns.

If you go this route for all or part of your U.S. stock exposure: Morningstar believes that stock investors greatly improve their chances of success if they focus on two key tasks: finding high-quality businesses with sustainable competitive advantages, or "moats," and paying a reasonable (or better yet, low) price for them. Morningstar.com includes screens for wide-moat companies that are trading at reasonable prices currently. *Morningstar StockInvestor* and *Morningstar DividendInvestor* newsletters also focus on companies with those attributes; *DividendInvestor* places a special emphasis on reasonably priced companies that produce income.

Mutual Funds

Why: Buying a diversified U.S. equity mutual fund gives you instant exposure to a broad cross-section of companies. You'll also gain access to professional management and analysts: Even if you opt for an index fund, the mechanics of managing the fund will be overseen by a professional manager and traders. Outsourcing the management and trading of individual stocks frees you up for other tasks, such as setting and monitoring your portfolio's overall asset allocation. As an owner of a fund, you'll also be able to obtain institutional-level (read: lower) trading costs.

Why not: Professional management isn't free. You'll pay for the fund-management personnel—its managers, analysts, and traders—and you'll also pay your share of operating costs to cover everything from the fund's website to shareholder reports. It's also worth noting that professional management doesn't guarantee better results than what you might be able to achieve with your own hand-selected basket of individual stocks. A fund's portfolio performance may also be affected by investor dollars flowing into and out of the fund; for example, a big influx of assets could cause the fund to have more cash than usual, or sizable redemptions could force the manager to sell shares he or she would rather hang onto. Mutual funds—especially actively managed ones—may also foist unwanted capital gains distributions on their shareholders, a problem that you can avoid by buying and holding individual stocks. (Equity investors can, however, reduce the problem of unwanted capital gains distributions by buying broad-market index funds and especially exchange-traded funds.)

If you go this route for all or part of your U.S. exposure: Start with Morningstar Medalist funds to winnow down the universe to a more manageable group; our analysts believe these funds will outperform their peers in the future. They’re available on Morningstar.com.

Choice 2: Will you buy an index fund or go with an actively managed fund?

If you've decided to invest in a mutual fund for your U.S. stock exposure, your next decision is whether to buy an index fund that tracks a benchmark—rather than attempting to beat it—or a fund whose manager picks individual stocks in an effort to beat the benchmark. As with the

decision about whether to buy individual stocks or a fund, the decision about whether to go with an active or index fund isn't black and white; it's possible to hold both. Here are the pros and cons associated with each strategy.

Index Funds

Why: Index funds—sometimes called passively managed funds, in contrast to those run by active managers—give you broad exposure to a given market segment (or segments), often at very low cost. Index funds come in two main subtypes: traditional index mutual funds and exchange-traded funds. Exchange-traded funds (ETFs) are similar to traditional mutual funds except that investors can trade them throughout the day, just as they can with individual stocks. Thanks to their cost advantage relative to actively managed funds, as well as the fact that their trading costs are very low, broad-market index funds have generally beaten the typical active fund over long periods of time. With a passively managed fund, you don't have to worry much about management or strategy changes, since what you hold is dictated by what's in the index. Broad-market equity index funds also tend to have good tax efficiency, meaning that they make few capital gains distributions on a year-to-year basis. (Investors who own index funds in their taxable accounts will owe taxes on any dividends they receive as well as when they sell, however, so you can't skirt taxes altogether by owning an index fund.)

Why not: You'll never beat the market or mitigate overall market losses with index funds. You'll just capture market returns (or losses) minus the fund's fees. Because index funds will always stay fully invested and allow their winners to appreciate, they frequently perform well when the market is going up. On the flip side, because index funds are required to stay fully invested and mirror the index's holdings at all times, their managers won't have the opportunity to raise cash or retreat from overvalued securities if they think the market is pricey. In practice, broad-market index funds make few changes to their portfolios, and when they do, it's usually around the margins. But index funds focused on a specific slice of the market—such as small-cap or value stocks—may make changes more frequently, and that can result in capital gains payouts if they've had to sell winners.

If you go this route for all or part of your U.S. exposure: Pick low-cost funds, because basic index funds are essentially interchangeable. It's also important to understand the index methodology; some newer index products will add other factors, so know what you're getting into.

Active Funds

Why: Good active managers may be able to beat the market—perhaps not in each calendar year but over a full market cycle—by implementing sound, proven strategies. Active managers also have the potential to mitigate losses in bad stock markets by retreating to cash and/or avoiding overpriced or otherwise unattractive parts of the market. Active managers can also take advantage of periods of market volatility to pick up stocks on the cheap.

Why not: You'll typically pay a higher price for an actively managed fund than you will for an index product or ETF. And because they generally have higher turnover, active funds also tend to have higher tax costs than index funds. To beat the market, active managers have to bet against it, which means they will also underperform the market sometimes. Active funds can be more volatile (and harder to own) than index funds: Even some great managers can stumble for long stretches after winning streaks. Other times, active funds end up looking like the index (index huggers), even though you are paying more than index fund fees for them; this is a particular problem for active funds that have grown too large. Nor does investing in a given active fund ensure that you'll be able to obtain exposure to a specific pocket of the market; active funds' prospectuses typically give their managers broad leeway to invest in companies of all sizes and styles. Finally, active funds require more monitoring than index funds. In addition to keeping an eye on a fund's strategy, you'll also need to pay attention to management issues: changes at the helm, of course, but also the fund's analyst team and stewardship issues at the fund's parent company.

If you go this route for all or part of your U.S. exposure: Bear in mind that the average active manager can't beat the index over time, so it's important to pick a better-than-average manager. Pick actively managed Morningstar Medalist funds, don't pay too much, and understand when the strategy will be in and out of favor so you capture the benefit and avoid mistiming purchases and sales.

Choice 3: Mirror the U.S. market or tilt your exposure?
The simplest, most hands-off, and invariably the lowest-cost way to obtain U.S. equity exposure is to buy a total U.S. market index fund and call it a day. But investors may be attracted to a certain type of stock—dividend payers, for example—or they may want to emphasize a given market segment because they like its long-term growth prospects. Historical market data indicate that certain slices of the market have tended to outperform the broad market, and that has fueled an interest in portfolio "tilts." (Such tilting strategies are often called "strategic beta.") Here are the pros and cons of incorporating tilts into your U.S. equity portfolio.

Why tilt: Whether you use stocks or funds to gain access to the U.S. market, you may choose to intentionally tilt your exposure to one area or segment of the U.S. market for a specific reason. If you're looking for current income, you may choose to focus on dividend payers. Value stocks or small caps can give you exposure to additional risk factors that may boost returns over the broad market in the long run. A high-quality/low-volatility tilt has been shown to add value over time. Data also suggest that momentum—the tendency for strong-performing securities to continue to outperform and weak ones to lag—can be a persistent force in market performance.

Why not: There's no free lunch in the market. Although index-fund and ETF providers have launched a raft of low-cost products that focus on specific slices of the market, building and

maintaining a portfolio with tilts is still likely to be more costly than buying and holding a plain-vanilla total U.S. market index fund. Moreover, factors or tilts come with trade-offs and can go in and out of favor, just like an actively managed fund. Dividend payers, especially high-quality ones, may be sensitive to interest rates, taking a hit as rates rise. Focusing on high-quality stocks can mean your portfolio lags during strong rallies. Small caps can be more volatile and less liquid than large. Value stocks may be selling on the cheap for a good reason. And even though past market data may indicate that a certain slice of the market has outperformed in the past, there's absolutely no guarantee it will do so in the future.

If you go this route for all or part of your U.S. exposure: Make sure you're taking these bets intentionally and know why you're taking them. Morningstar.com's X-Ray tool can help you identify factor tilts in your portfolio by showing you your portfolio's exposures alongside the S&P 500's. Also, understand the kinds of conditions that cause tilts to be in and out of favor. That will not only help you avoid tilting in and out at the wrong time, but it can also help you stick with your portfolio even when it's underperforming the broad market. And if you incorporate tilts into your portfolio, make sure you're not overpaying for those exposures. M

4 Questions to Ask When Investing in Foreign Stocks

Think through product type, emerging-markets exposure, currency stance, and more.

By Christine Benz

Imported goods are so ubiquitous in our lives that we hardly give them a second thought. As I sit in my home office, I'm clacking away on my laptop from a U.S. company and talking on a cell phone from a U.S. maker, too. But I'm not far from a Korean-made TV, and there can be little doubt that the plate I ate my lunch on was made in China.

Just as most imported goods are no longer even remotely exotic, investors are becoming increasingly comfortable with foreign stocks in their portfolios, too. To make good decisions about your foreign-stock holdings, it's important to give some consideration to the amount of initial research and ongoing oversight you're willing to dedicate to your portfolio, how much volatility you're willing to tolerate, and whether you want to shoot for market-beating performance or are comfortable holding an index basket of foreign stocks (and the low costs that come along with such a strategy).

Thinking through the following choice sets can help you arrive at the right answer for you.

Choice 1: Will you invest in individual stocks or funds?
As with investing in U.S. stocks, your first decision when investing in foreign stocks is whether you will invest in individual stocks or in some type of managed product—a mutual fund, index fund, or exchange-traded fund. And as with U.S. investing, it's perfectly reasonable to do both, to invest directly in individual foreign stocks—especially blue chips such as American depositary receipts (ADRs), where trading costs are apt to be low and disclosure high—while employing funds to obtain exposure to less liquid parts of the international stock market. Here are the pros and cons of each tack.

Individual Stocks

Why: Investors in individual stocks have the opportunity to generate strong, even market-beating returns by concentrating their investments in a well-researched basket of individual stocks. Individual-stock investors can also avoid the management fees that accompany mutual funds and ETFs. But if they venture beyond American depositary receipts, which allow them to buy stakes in foreign companies trading on a U.S exchange, their transaction costs are apt to be higher than what they would pay for U.S. blue chips. Bid-ask spreads may also be large when purchasing securities on foreign exchanges, further increasing trading costs. Of course, such costs are also borne by funds, and in fact, foreign-stock fund expenses are generally

higher than is the case with U.S. stock funds. But as larger entities, funds may more readily be able to benefit from economies of scale than individual-stock investors can.

Why not: Investors in individual stocks may have more concentrated portfolios than what they would be able to obtain through a mutual fund, and therefore, their portfolios' volatility could be higher. And if they venture beyond blue-chip multinationals, whose shares are listed on U.S. exchanges, individual-stock investors may find it difficult to thoroughly research prospective holdings: Different countries take varying approaches to shareholder disclosures. Costs may also be higher.

If you go this route for all or part of your foreign-stock exposure: Morningstar's philosophy for investing in stocks transcends geography. As with investing in the U.S. market, we believe that foreign-stock investors improve their chances of success if they focus on high-quality companies with sustainable competitive advantages—or moats—and aim to pay a reasonable price for them. Investors can use the screening tools on Morningstar.com to identify companies that fit the bill.

Mutual Funds

Why: Whereas the investor in individual foreign stocks may have a difficult time researching and building a portfolio that's well diversified by geography, company size, style, and sector, an investor in a well-diversified mutual fund gets instant diversification. The fund investor can also rely on professional managers to do the heavy lifting on researching companies and navigating varying disclosure regimes.

Why not: Professional management entails costs, and foreign-stock funds typically charge even more for their services than U.S. stock funds do. That can cut into the returns investors earn on their foreign-stock holdings. Mutual funds can also foist unwanted capital gains on their shareholders, whereas individual-stock investors exert a higher level of control over capital gains realization. The taxes that foreign companies levy on their dividends can also end up denting some investors' returns, even though investors receive a tax credit for them.

If you go this route for all or part of your foreign-stock exposure: Start with Morningstar Medalist funds to winnow down the universe to a more manageable group; our analysts believe these funds will outperform their peers in the future. You'll find them on Morningstar.com.

Choice 2: Will you buy an index fund or go with an actively managed one?

It's the $64,000 question for all investors who have decided to buy a mutual fund: Invest with a passive index tracker or go active? In the past, conventional wisdom was that international investing was a good place to go active, but international index funds are on the ascent. Index-based foreign-stock mutual funds have also been seeing strong asset inflows because

their long-term returns have been competitive with—or better than—their actively managed counterparts. Index funds come in two main subtypes: traditional index mutual funds and exchange-traded funds, which enable investors to trade them throughout the day. Here are the pros and cons associated with each strategy.

Index Fund

Why: Foreign-stock index funds give you broad exposure to the foreign markets (or segments of them) in a single shot, often at very low cost, enabling you to get away with a very minimalist portfolio. Thanks to their cost advantage relative to actively managed funds, as well as the fact that their trading costs are very low, broad-market index funds have generated long-term returns that are competitive with—or better than—the foreign-stock fund category average. Nor are strategy or management changes apt to be an issue with market-cap-weighted index funds. Broad-market equity index funds also tend to have good tax efficiency, meaning that they tend to make few capital gains distributions on a year-to-year basis. (Investors who own index funds in their taxable accounts will owe taxes on any dividends they receive and capital gains when they sell, however.)

Why not: Although their returns are competitive with actively managed foreign-stock funds' returns, investing in an index fund all but ensures that you'll lag the benchmark by your fund's expense ratio. On top of that, index funds do not have the ability to retreat from dicey markets when the going gets tough, which is a technique that investors might value in a foreign-stock fund even more than in a U.S.-focused fund.

If you go this route for all or part of your foreign-stock exposure: Pick low-cost funds, because basic index funds are essentially interchangeable. It's also important to understand the index methodology. Morningstar's list of foreign-stock medalist funds includes a heavy complement of index funds.

Active

Why: At first blush, active management seems especially appealing for foreign-stock funds. Foreign-stock managers typically have wide discretion over their portfolios' geographic exposure, enabling them to emphasize more profitable regions and de-emphasize problem spots. Index funds, meanwhile, have no choice but to mirror their benchmarks' exposures. Because it's arguably harder to research foreign companies than it is U.S. companies, savvy foreign-stock investors may also be able to gain a performance edge by unearthing hard-to-come-by information about the companies in which they've invested.

Why not: As with U.S. equities, you'll typically pay a higher price for an actively managed foreign-stock fund than you will for an index product or ETF. Active funds also tend to incur higher tax and transaction costs than index products, because their turnover is also higher. Moreover, investing in an active fund requires more patience than buying a passively managed

product, because active managers' styles will periodically fall from favor, sometimes for long stretches. Finally, active funds require more monitoring than index funds.

If you go this route for all or part of your foreign-stock exposure: Morningstar's medalist list, available on Morningstar.com, includes a number of topnotch actively managed foreign-stock funds. In general, they're cheaper than their peers, boast long-tenured management teams that aren't shy about looking different from their competitors, and hail from firms that are strong stewards of shareholders' capital.

Choice 3: Will you emphasize emerging markets?

One of the other big decisions for foreign-stock investors is how much to invest in emerging markets, which tend to have higher volatility than developed foreign markets but also have higher growth and therefore, many investors assume, the potential for higher long-term returns.

Investors can approach this decision in a few different ways. Because emerging markets tend to have higher volatility than developed, they can circumvent emerging markets altogether—investing in an MSCI EAFE fund or an actively managed fund that systematically downplays emerging markets. On the flip side, if they're enthusiastic about emerging markets, they can layer on a dedicated emerging-markets fund or invest heavily in a diversified foreign-stock fund that buys heavily into emerging markets. As a middle ground, they can mirror the global market capitalization's weighting in emerging markets. Depending on the index and how it defines emerging markets, between 15% and 20% of overseas companies are currently domiciled in emerging markets. Here are the key pros and cons of emphasizing developing markets as a component of your foreign-stock portfolio.

Why emphasize: The key reason to invest in emerging markets is that economic growth rates have typically been higher than is the case with developed foreign markets. And because these markets are less liquid and still less heavily followed than developed, savvy investors may be able to sleuth out attractive opportunities that haven't been widely recognized by other investors. Emerging markets may also be subject to geopolitical and other market shocks that cause broad-market sell-offs. While not fun to go through, such downturns can translate into buying opportunities for savvy value investors.

Why not: Although economic growth has historically been higher in emerging markets than in developed, it has slowed in recent years. More importantly, there's no clear connection between GDP growth and long-term market performance, and emerging markets typically feature higher volatility than developed foreign markets. Shareholders in companies domiciled in emerging markets may also have fewer rights than shareholders in companies from developed markets.

If you emphasize emerging markets: Investors seeking emerging-markets exposure can take a few different tacks. They can invest with a diversified foreign-stock fund with a history of investing in emerging markets; they can buy a dedicated emerging-markets fund; or they can focus on a particular region within emerging markets, such as Latin America. Morningstar's medalist list homes in on top funds of all three persuasions.

Choice 4: Will you hedge your foreign-currency exposure?
Another consideration for foreign-stock investors is what tack to take with foreign currencies. This is an important decision because, as a U.S. investor, your return from foreign stocks consists of two elements: any gains or losses in the securities of the portfolio, as well as any gains or losses in the foreign currency versus the dollar over the holding period. If the stock appreciates and the currency in which it is denominated appreciates relative to the dollar over your holding period, you win on both sides of the trade. But if the stock declines and the foreign currency declines, too, it's a lose-lose.

Because foreign-currency fluctuations can be a big component of a foreign-stock investor's return, some investors aim to erase, or at least reduce, foreign-currency effects using a technique called hedging. Here are the pros and cons of incorporating hedging into your foreign-stock-investing strategy.

Why hedge: There are a few key reasons one might hedge foreign-currency exposures. A key one is if you expect the foreign currency to decline relative to the dollar—in that case, you'd like to cut those foreign-currency effects out of your return. Another is if you know you're no good at predicting foreign-currency movements but instead want your return to be a pure reflection of the securities' return—you don't want any foreign-currency-related noise.

Why not: A key reason to maintain an unhedged portfolio is that foreign-currency swings can be a source of diversification for your portfolio. Another, perhaps even more persuasive reason not to hedge is that foreign-currency fluctuations are notoriously difficult to predict. And in any case, foreign-currency swings tend to balance each other out over long periods of time. Finally, because foreign-currency hedging is typically accomplished by buying futures contracts, there are costs associated with doing so, which can cut into returns.

If you decide to hedge: There are a few different ways to hedge your foreign-stock portfolio's currency exposure. The most straightforward way would be to buy a mutual fund that does the hedging for you, such as Tweedy, Browne Global Value (TBGVX). If you determine that you'd rather not hedge, you have a broad range of options from which to choose. Plain-vanilla foreign-stock index funds never hedge their currency exposures, though many hedged foreign-stock exchange-traded funds have hit the market in recent years. M

4 Key Questions to Ask When Investing in Bonds

Think through all of the variables when developing your fixed-income portfolio.

By Christine Benz

You've used asset-allocation calculators and compared your portfolio to target-date funds geared toward your retirement date. You may have even checked in with a financial advisor for a temperature check. And all systems point in the same direction: It's time to add some bonds. Check that—it's way past time to add some bonds.

But if you're like many investors—even seasoned ones who have long been navigating the stock market—you may be balking. Even if you're willing to swallow your misgivings about bonds' meager yields and the risk that rising rates could crunch bond prices, you may be dogged by a more basic issue: where to start?

If you find yourself in this situation, it's helpful to consider your major choices one by one. By the time you're through, you'll be well on your way to assembling a bond portfolio that makes sense for you given how much time you want to devote to your portfolio, your opinions on active versus passive management, your desire for diversification, and so on.

Choice 1: Will you buy individual bonds or bond mutual funds?
The first decision bond investors must make is the delivery system: individual bonds or a bond fund? For most investors, especially those starting out, the simplicity, diversification, and professional management that come along with investing in a bond fund can be difficult to beat. But individual bonds may be appropriate in some instances. Here are the pros and cons of each strategy.

Individual Bonds
Why: The key benefit of buying individual bonds is that you can readily match the bond's maturity to your time horizon. Assuming you've bought a bond from a high-quality issuer, you'll receive your coupon payments and get your principal back when the bond matures, even though interest rates may have moved up, down, and sideways over your holding period. And by buying individual bonds, you can, in theory, cherry-pick the bonds that offer the best combination of safety and yield. You can also circumvent fund-management fees, but you'll face other costs as an individual-bond buyer. So, those cost savings could be illusory.

Why not: While the marketplace for individual-bond buyers has improved over the past decade, it can still be tricky to research individual bonds' fundamentals and determine whether the price you're paying is a fair one. This is especially true once you venture beyond

government-issued and high-quality corporate bonds. Trading costs can also eat into the returns that small investors earn on individual bonds. It can also be difficult, as a smaller investor, to build a portfolio of individual bonds that's adequately diversified; one bum holding can disproportionately affect your results. Moreover, the assumption that individual bonds protect you from rising interest rates is not exactly true. If rates go up, your choices are to stick with your lower-yielding bond—and face an opportunity cost—or to sell your bond at a discount to swap into a higher-yielding investment.

If you go this route for all or part of your bond exposure: Focus on very high-quality, highly liquid bonds and make sure you fully understand all of the costs and risks that come along with making the investment.

Bond Mutual Funds

Why: Fund investors—even small ones—get diversification and professional management in a single shot by investing in a bond fund. And while a bond fund may incur short-term losses when interest rates rise, the bond-fund manager will then be able to swap into new, higher-yielding bonds as they become available, thereby offsetting the hit to principal. Large institutional investors, like mutual funds, will also be able to obtain lower trading costs than small investors; in a low-returning asset class like bonds, that can be a major advantage.

Why not: The fees you pay for fund management may cut into your return. And there's no guarantee you'll be able to take exactly as much out of your bond fund as you put in. If interest rates rise over your holding period or if the types of bonds in the portfolio slump for some other reason, you could have a loss in your holdings.

If you go this route for all or part of your bond exposure: Be sure to start building your bond-fund portfolio with core, intermediate-term funds that give you a lot of diversification in a single holding. Be careful with funds that focus on a narrow part of the market or have high costs, as high expenses correlate neatly with risk-taking among bond funds.

Choice 2: Index funds versus actively managed funds?

If you've decided to focus on funds, your next question is the same one that confronts equity-fund investors: buy an index fund that tracks a specific bond-market benchmark without trying to beat it or employ an actively managed fund? Here are the positives and negatives of both approaches.

Index Funds

Why: The key advantage to indexing is the ability to obtain exposure to an asset class at a very low cost. Both traditional bond index funds and exchange-traded funds—index funds that can be traded on an exchange throughout the day—tend to have very low expenses. Those low costs are a particularly big advantage for bond funds, because the range of returns in high-quality bond categories is very narrow. The Barclays U.S. Aggregate Bond Index, which

many index bond funds track, tilts heavily toward the highest-quality bonds; thus, the index has historically held up well in periods of equity-market weakness. Active bond managers have been able to beat the index handily at various points in time, but the index has offered strong diversification for equity portfolios.

Why not: Index funds don't have the same flexibility that many active fund managers do—they can't retreat to cash in periods of rising rates, for example. Moreover, some critics have argued that the Aggregate Index isn't representative of the U.S. bond market because it places too much emphasis on U.S. government bonds. The Aggregate Index isn't entirely inclusive, either: For example, it omits Treasury Inflation-Protected Securities and junk bonds.

If you go this route for all or part of your bond exposure: Search for the cheapest fund you can find, because bond index funds are a commodity. Also, make sure you understand the index's construction and, if you're searching for all-inclusive bond exposure, be sure to augment your core bond index fund with the security types it's missing.

Active Funds

Why: The main attraction behind active funds is the ability to outperform a market benchmark and to get away from trouble spots. As the U.S. economy recovered in the years following the financial crisis of 2007-2009, for example, investors flocked to active bond funds because of their perceived ability to avoid big losses in interest-rate increases. Some of the best active bond funds keep their expenses very low, giving their managers a fighting shot at beating the benchmark without taking on excessive risks.

Why not: Active funds are generally more expensive than their indexed counterparts, and that can weigh on both absolute and relative returns. Moreover, some active funds operate with tightly constrained mandates, so in practice they may not be able to deliver the level of outperformance that investors are expecting. Alternatively, an active fund could position the fund one way and the market could go the other; manager bets aren't always vindicated.

If you go this route for all or part of your bond exposure: Seek out a proven manager with deep analytical resources. Don't expect all-weather performance, either: High-quality-focused funds tend to behave better in periods of economic and equity-market uncertainty, while lower-quality funds tend to thrive when the economy and stocks are also going strong. Make sure you understand which type you have.

Choice 3: Diversify internationally?

If you've determined what the core of your bond portfolio will look like, you can stop right there. But many investors have embraced international bonds as a means of further diversifying their bond portfolios. Here are the key pros and cons of doing so, as well as details for some of the variations of international bond-fund types.

Why diversify internationally: Diversification is the main benefit of owning foreign bonds. Even if you buy a fund that hedges its currency exposure—that is, uses futures contracts to negate the impact that foreign-currency swings can have on returns—you can still pick up exposure to countries' varying interest-rate climates, and that can help improve the risk/reward profile of your bond portfolio. Unhedged international-bond funds tend to offer even greater diversification for U.S. bond portfolios, but their volatility is sky-high, too.

Why not diversify internationally: Unhedged international-bond funds are good diversifiers for U.S.-focused bond portfolios, but the high volatility that accompanies foreign-currency swings makes them inappropriate for investors with short or intermediate time horizons. Hedged foreign-bond funds are much less volatile, but it's debatable whether their modest diversification benefit offsets their management fees and hedging costs. Generally speaking, foreign-bond exposure will cost you more than a U.S.-focused bond fund or ETF.

If you go this route for all or part of your bond exposure: Make sure that you fully understand the fund's strategy. In addition to the hedged versus unhedged distinction, international-bond funds vary in whether they invest in U.S. bonds as well as foreign, whether they buy government or nongovernment bonds, and how much, if anything, they invest in emerging markets. Also, understand how the international-bond fund fits in your portfolio; you may already have some international-bond exposure via your intermediate-term, multisector, or nontraditional bond fund.

Choice 4: Tilt your portfolio's exposures?

As with equity portfolios that emphasize stock types like dividend payers, small caps, or value stocks, bond portfolios may also tilt toward certain parts of the bond market—either on a short-term tactical or long-term strategic basis. The goal may be return enhancement, risk reduction, or both. Here are the pros and cons of incorporating tilts into your portfolio.

Why tilt: Investors may incorporate tactical tilts in an effort to capitalize on short-term market dislocations or to avoid trouble spots—as the economy recovered in the wake of the financial crisis, for example, many investors tilted their portfolios toward cash and short-term bonds in an effort to shield their portfolios from losses arising from rising interest rates. Alternatively, investors may maintain long-term strategic tilts to enhance their portfolios' long-term risk/reward profiles. For example, high-quality corporate bonds have historically delivered higher returns than U.S. government bonds without substantially higher volatility.

Why not tilt: The big risk with tilts—either opportunistic, tactical ones or those that are long term—is that your portfolio will be leaning in one direction and the market will go the other. The many fund managers and individual investors who maintained short-duration portfolios because they expected interest rates to rise in the years following the financial crisis, for example, have faced an opportunity cost as interest rates have stayed quite low.

If you go this route for all or part of your bond exposure: There are a few ways to implement tilts in your fixed-income portfolio. You can implement tilts yourself, emphasizing, for example, short-duration or more credit-sensitive bond types. Alternatively, you can outsource that decision-making to a professional fund manager to implement the tilt for you. M

The 5 Fundamentals of Fund Investing

These are the big, funda¬mental areas that have proved vital to a fund's long-term success.

By Russel Kinnel

Here at Morningstar, we've been analyzing mutual funds since the late 1980s. Our analysts evaluate funds based on their long-term potential for superior risk-adjusted performance. We judge each fund's competitive advantages and disadvantages. In 2011, we introduced our Morningstar Analyst Rating. Our ratings have five levels: Gold, Silver, Bronze, Neutral and Negative.

The ratings reflect a synthesis of each fund's funda¬mentals—and it's our philosophy at Morningstar that to be successful, fund investors must understand a few key fundamentals. We break those fundamentals down into five "pillars": People, Process, Parent, Performance, and Price. These are the big, funda¬mental areas that have proved vital to a fund's long-term success.

Let's take a look at each pillar that we consider when evaluating funds.

People

To understand a mutual fund, investors must understand the people behind them.

There is much more to a fund than its manager. There are the analysts, traders, and other managers who contribute to the process, and we consider all of them when assigning our ratings. We think about what advantages they have over their peers along the lines of expertise, experience, and demonstrated skill. A lot of work goes into assessing the people. We talk with managers on a regular basis, we visit fund companies to meet the people behind the scenes (such as analysts and chief investment officers), and of course we pore through piles of shareholder reports, press interviews with the manager, and SEC filings that show how much a manager has invested in the fund.

We also look at how other funds at the family have done to assess firm-wide expertise. We follow analyst movements at the firm so we know how experi¬enced they are and whether there's turmoil or stability in the ranks.

A negative People score does not mean we think the manager is dim or disagreeable. It could mean that the firm hasn't demonstrated expertise in that area, the research bench isn't sufficient or stable, or the manager has not established a track record.

Process

There's an enormous variety of fund strategies even within a category: Decide that you want a large-cap growth fund and you will need to find out whether the manager is taking a momentum-based approach or focusing more on growth at a reasonable price, for instance.

At Morningstar, we drill down to really understand the differences. Competitive advantages are a key way to look at it. Is the manager doing something that anyone can do, or is he or she doing things that are hard to replicate? Is the strategy a proven one or a new, untested formula?

Just as important is how well the process is matched to the managers' and firm's skill sets. For example, PIMCO runs some very involved derivatives strategies. While those are not without risks, the firm has the resources and track record to give us confidence. Someone running a three-person office would be a terrible fit for such a strategy. Mutual Series is another example of a family with a strong process. It has a deep fundamental-value strategy that it has had tremendous success with, and everyone at the firm is steeped in that investing outlook. Short of hiring away some people from the firm, it's not something just anyone can replicate.

Parent

When you invest for the long haul, you realize just how important the company behind the fund is.

In our analysis, we look at manager turnover at the firm, investment culture, quality of research, ethics, directors, SEC sanctions, and more. If you hold a fund for 15 years, you want stable management that will be there the whole way through. Failing that, you want a firm with a deep bench with people who can step in and keep the fund going along the right path. What you really don't want is frequent switches with not-very-talented investors.

You'll also find that a fund company and the fund board make a number of decisions that have a big impact on the fund. Some clearly pit the company's short-term profits versus fundholders' long-term interests. For example, if they are maximizing short-term profits at the firm, they won't close a fund even if further assets could impair performance and they keep fees higher than necessary. Or they might, to the detriment of shareholders, merge two funds with distinctly different strategies. Firms seeking near-term gains sometimes launch funds that may be hot sellers but aren't great investments and won't lead to good investor outcomes. In short, you want a partner you can trust for many years to come.

Performance

Performance may seem like the easiest element to evaluate: After all, there are plenty of indexes and categories to compare a fund's performance with.

Investors generally do not evaluate fund performance accurately. At Morningstar, we focus on performance under the current manager to tell us whether he or she has added value. The longer the record, the more predictive it is of future relative performance. Although some investors tend to weight recent returns more highly, it's really the long-term record of a manager that is most telling.

We spend time trying to understand why a fund performed a certain way, and we link the performance back to its root cause: the strategy and holdings. We care about how a fund has performed in different market environments, its risk profile, and its consistency of returns over time. It's important to understand what risks a manager took and is taking now to generate the returns. Some higher-risk strategies can enjoy a nice steady ride for a few years before all hell breaks loose.

We'll also look beyond the fund when necessary and appropriate by considering managers' records at other funds (current and past) as well as other accounts they may have run, such as separate accounts or hedge funds.

Price

Costs are a good predictor of future performance. They aren't every¬thing, but they are a crucial piece in the puzzle. You need to consider fund costs when investing.

At Morningstar, we look at a fund's expenses relative to its peer group and its sales channel. We also take into context its asset size and in some cases its trading costs if they are particularly high or low. It's also important to consider a fund's costs in light of its strategy. M

Section 3
Continue to Evolve

Continue to Evolve

Check These 7 Retirement Blind Spots

Proper planning can help you avoid these nasty financial shocks in retirement.

By Christine Benz

Your investment portfolio, despite the market ups and downs of the past few months, looks tantalizingly large. Social Security will provide a surprisingly high percentage of your basic income needs.

Maybe retirement is more doable than you thought, sooner than you thought.

But don't limit your retirement readiness check to an assessment of your account balances and your Social Security payments. Make sure that you're considering the whole gamut of financial-planning considerations in retirement—especially new expenses and costs that you might not have had to contend with when you were working—when determining whether you're really ready to hang it up.

What follows are some of the financial realities of retirement that have the potential to blindside new retirees who don't plan for them.

That you could encounter a down market early on in retirement: Market volatility in early 2016 provided a reminder that retirement-portfolio balances can decline. And encountering a bum market, especially early in retirement, can change the math on the viability of retirement in short order. If your $1 million portfolio were to drop by 25% next year, your $40,000 annual withdrawal would jump from 4% to more than 5% in the space of a year. That might not be catastrophic, but financial planners usually advise pre-retirees to build in some variability in their in-retirement spending programs so that they spend less in down markets, especially if those down markets happen early in their retirement years. I also like the idea of "bucketing"—holding enough cash and bonds to ensure that you're never going to have to sell stocks to meet living expenses when they're in a trough.

That your health-care costs may well go up: Some retirees incorrectly assume that turning 65 and being Medicare-eligible means that health-care costs automatically go away. But Medicare covered roughly 60% of the health-care expenditures for retirees, according to a 2012 report from the Employee Benefit Research Institute. Factoring in supplemental insurance premiums and out-of-pocket expenditures, among other health-care outlays, Fidelity Investments estimated in 2015 that the typical 65-year-old couple will need $245,000 to cover health-care expenses during their retirement years. Importantly, that figure does not include long-term-care expenditures. Of course, retirees' health-care expenses vary widely and may

change over time; some retirees may be covered by an employer-provided plan. That's a shrinking share of workers, though: A Kaiser Family Foundation report noted that 25% of firms with more than 200 employees offered retiree health-care benefits in 2014, down from 38% in 2004.

That inflation will take a bite out of your withdrawals: Gas prices provide a regular, visible gauge of whether costs are going up or down. But most price changes are far more subtle and easy to ignore: The pasta box that was 16 ounces shrinks to 14, or the cable bill (don't get me started on the cable bill!) jumps by $20. Over time, those minor cost increases, both direct and indirect, mean that you'll need to spend more to maintain a steady standard of living. That's why it's so important to make sure that you're factoring in the role of inflation when assessing the viability of your plan—an amount that you can live on today may not be enough to get by on in 10 years. Spending guidelines like the 4% "rule" factor in the role of inflation by assuming the retiree spends 4% of her portfolio balance in year one of retirement and then gives herself a small raise annually to account for inflation. It's also valuable to make sure that your portfolio has a fighting shot at out-earning inflation via direct inflation hedges like Treasury Inflation-Protected Securities as well as indirect hedges such as stocks.

That you'll owe taxes on your withdrawals from tax-deferred accounts: Balances for Traditional (not Roth) IRAs and 401(k)s are a bit of an optical illusion, in that they look fatter than they actually are. While you enjoyed pretax contributions and tax-deferred compounding while you were accumulating money there, you'll owe ordinary income tax on each and every one of your withdrawals. That underscores the importance of making sure that you factor in the bite of taxes when crafting your retirement-spending plan, as well as the merits of tax diversification—making sure you come into retirement with accounts that will enjoy varying tax treatment, including Roth and taxable assets.

That you'll be responsible for managing your own tax outlays: Self-employed individuals well know the importance of setting aside enough from each payday to cover taxes. But for retirees who spent most of their lives receiving a paycheck that took taxes out automatically, covering their state and federal tax bills on their own may take some getting used to. Retirees can manage their ongoing tax obligations by withholding a percentage of their retirement-portfolio withdrawals at the time they take them, by paying estimated taxes, or both. A tax advisor can help you make sure that your ongoing tax outlays during retirement aren't so low that you'll incur a penalty, and aren't so high that you're giving the government an interest-free loan.

That you'll be on the hook for required minimum distributions: Wealthy retirees may find themselves in the enviable position of not needing their IRAs; they can draw their income from other sources and continue to take advantage of tax-sheltered compounding that the IRA wrapper affords. That's a fine strategy if the IRA assets are Roth, and it's even a workable

approach with traditional IRA assets in the early retirement years. But required minimum distributions begin in the year in which you turn age 70 1/2, and if the IRA is a large one, your tax bill may well go up right along with those distributions. Here again, tax diversification can come in handy, as withdrawals from Roth and some taxable assets may help retirees offset the tax bills from their RMDs. (Note that Roth IRAs aren’t currently subject to RMDs, but a proposal in President Obama’s budget outline for fiscal year 2017 include a provision that would add RMDs to Roth IRAs.) Retirees should also bear in mind that the RMD doesn't mean those assets must be spent; you can reinvest them in your taxable account or even in a Roth IRA if you don't need the money. (You need earned income to make a Roth IRA contribution.)

That you might not be able to continue to work: Continuing to work at least part time is a fact of life for many of today's "retirees"; they may do so by choice or because it's the only way to make the numbers add up for their retirement. But while there are certainly several important financial advantages associated with working longer—delayed receipt of Social Security benefits and delayed portfolio withdrawals are two of the biggies—working longer may not be tenable for everyone. While a third of the workers in a 2014 Employee Benefits Research Institute survey said they planned to work past age 65, just 16% of retirees said they had retired post-age 65. And a much larger contingent of retirees—32%—retired between the ages of 60 and 64, even though just 18% of workers said they plan to retire that early. The disconnect owed to health considerations (the worker's, his or her spouse's, or parents'), unemployment, or untenable physical demands of the job, among other factors. M

Learn Your ABCs Before Hiring a Financial Advisor

Make sure you know what all those credentials mean before seeking help with your finances.

By Morningstar.com

Question: In shopping around for a financial advisor, I often see acronyms such as CFA or CFP after their names. What do these stand for and how do I know which are most important?

Answer: Seeking the help of a financial advisor can, at times, feel like wading through a bowl of alphabet soup. The list of acronyms that advisors typically attach to their names on websites and business cards may mean little to those unfamiliar with them. But if you're going to turn to a financial professional for help, you'll need to decode this series of letters to find an advisor that's a good match for your needs.

Before focusing on what specific acronyms mean, however, you'll need to keep in mind a few basics. First, be aware that generic titles such as financial advisor, financial planner, and financial consultant are essentially meaningless. Anyone can call themselves by these names and charge you money in exchange for advice. In fact, one reason so many acronyms exist in the world of financial planning is to provide consistency and—just as importantly—credibility to the titles used by financial professionals. Qualified financial advisors typically will have earned accreditation from a reputable organization in the financial industry, and many have earned more than one.

Be aware that not all designations are created equal. Some require heavy coursework, professional experience, ethics training, and rigorous testing, while others are less demanding. Many designations are highly specialized, and an advisor trained in one area may not be a good choice for another. Finally, don't assume that an advisor with many designations after his or her name is necessarily better than one with just one. The most important thing is to find an advisor who meets your needs, not one who collects credentials.

Following are some of the most common designations among financial advisors:

Certified Financial Planner (CFP): Financial planning expert accredited by the Certified Financial Planner Board of Standards.

Requirements: In order to use the CFP designation, planners must log at least three years of full-time financial planning experience, complete a CFP Board-certified educational program, and pass a 6-hour exam.

Helpful if: You are looking for a trained professional to provide comprehensive guidance on all of your personal financial matters. Certified financial planners often work closely with other experts, such as estate-planning attorneys and accountants, serving as the "quarterback" among all of these professionals.

Certified Public Accountant (CPA): Tax expert licensed by a state Board of Accountancy.

Requirements: To use the CPA designation planners must pass the Uniform CPA Exam and meet requirements set by the state Board of Accountancy.

Helpful if: You want your taxes prepared by an accredited expert, or you need tax planning advice.

Chartered Financial Analyst (CFA): Financial expert accredited by the CFA Institute.

Requirements: In order to use the CFA designation, advisors must have at least four years' work experience involving investment decision-making and take courses on subjects such as economics, financial reporting and analysis, ethical standards, equity and fixed-income investments, and portfolio management. They also must pass a series of three six-hour exams to be certified, with the CFA board estimating that at least 250 hours of study are required to pass each exam.

Helpful if: You are looking for a trained financial professional to analyze a specific investment or manage a portfolio but not necessarily to formulate a comprehensive personal financial plan.

Chartered Financial Consultant (ChFC): Financial planning expert accredited by The American College of Financial Services.

Requirements: In order to use the ChFC designation, advisors must have at least three years of full-time business experience and pass nine courses in topics such as financial planning, income taxes, investments, and estate planning with a proctored exam for each course.

Helpful if: As with a CFP, you are looking for a trained professional to help manage all your personal finances.

Chartered Life Underwriter (CLU): Insurance expert accredited by The American College of Financial Services.

Requirements: In order to use the CLU designation, advisors must have at least three years of full-time business experience in the five years prior to accreditation and pass eight courses in

topics such as insurance planning, life insurance law, and estate planning with a proctored exam for each course.

Helpful if: You need help specifically in the area of life insurance planning.

Registered Investment Advisor (RIA): Financial professional or firm registered with the SEC (if assets under management exceed $100 million) or state securities agency (if assets under management are less). Employees of an RIA firm may be designated as Investment Advisor Representatives, or IARs. RIAs and IARs have a fiduciary responsibility to serve in the client's best interests (broker/dealers are held to a lower standard). There is some controversy over financial advisors' use of the RIA designation. According to the SEC, "Advisers should not use the term 'RIA' after a person's name because using initials after a name usually indicates a degree or a licensed professional position for which there are certain qualifications; however, there are no federal qualifications for becoming an SEC-registered adviser."

Requirements: Those using the RIA designation and registering with the SEC must file a Form ADV that documents their activities and must provide periodic updates. At the state level, IAR applicants are typically required to pass the Series 65 exam or hold a designation such as CFP or CFA.

Helpful if: You are looking for an advisor who is under legal obligation to act in your best interest.

For information on other financial industry designations, a good place to start is the website of the Financial Industry Regulatory Authority (FINRA), which provides a lengthy list that includes requirements for each designation.

Do Your Due Diligence

In addition to finding a financial advisor with the right credentials, be sure to ask how he or she is paid. Advisors may charge you a percentage of assets held in the account, a retainer fee, an hourly rate for services, a flat fee, or a combination of approaches. Also, do a background check if possible, ask for referrals, and make sure to ask lots of questions to avoid any unpleasant surprises later on. Finally, ask people you know what they've liked or disliked about working with an advisor. M

Continue to Evolve

20 Common Investing Mistakes

By Russel Kinnel

I talk with investors almost every day, and over time the same themes emerge. Although investors cover the gamut of sophistication levels, I hear the same mistakes over and over again. So, to help save you from repeating the same mistakes and losing a lot of money to learn the lessons, I've jotted down 20 of the most common investing mistakes.

Most come down to two basic types of errors. One error is to let emotions get the better of you. I'm amazed at the reasons people build to justify making the investments that make them feel better even if, in the long run, they'll be poorer for having done them. The second error is to not build a plan and think things through. As one planner told me, "People don't know what they bought or why they bought it."

Mistake 1 | Reacting to short-term returns.
Every day, people go to their online 401(k) accounts and sell the fund with the worst one-year returns and buy the one with the best one-year returns. It makes them feel better, and they will tell you that the new fund is ahead of the curve and run by a smart manager and the old one has lost its touch. What they won't say is that they are buying high and selling low. Nor will they say that short-term returns are just noise. You are better off buying funds with lagging short-term performance than those with top-quartile returns.

Mistake 2 | Basing sell decision on cost basis.
You bought fund A at $10 and now its net asset value is at $5. You bought fund B at $10 and now it’s at $20. Which should you hold, and which should you sell? I have no idea. The amount you paid is relevant only to tax planning. What matters is which will have better returns over your investment horizon. If the answer is fund B, then sell fund A (you'll have a tax benefit if it's in a taxable account) and put the proceeds in fund B. The problem is that people have an emotional attachment to the price. Some are afraid to book losses, and others are too anxious to sell a winner for fear that they'll miss out on gains. What matters is whether the funds have strong fundamentals.

Mistake 3 | Selling after the market falls.
The short-term direction of the stock market is unpredictable; yet selling in reaction to market moves implies that you can predict short-term moves. The markets are not perfectly efficient from minute to minute, but they quickly reflect a best guess based on new information. Fear is one of the greatest enemies of successful investing. When you're worried about your money,

you want to make it safe. However, you risk missing out on the next rally, and you might not even keep pace with inflation. From a long-term perspective, cash is very risky and stocks are low risk. Put another way, this is another example of selling low and buying high. Savvy investors go bargain hunting when the market is oversold; you should, too.

Mistake 4 | Accumulating too many niche funds.
We get mailings all the time telling us about hot new investments. In 2007, commodity funds and Brazil, Russia, India, and China funds were the rage and the timing turned out to be terrible. These specialist funds are exciting and fun to buy, but they will mess up your portfolio if you let them. Most niche funds charge more than more-diversified funds, and they typically have third-tier managers and less analyst support. Yet you can get the same exposure to sectors and regions through more-diversified funds. Niche funds drive up your costs, add extra volatility, and make managing your portfolio more difficult.

Mistake 5 | Failing to build an overall plan.
This is a biggie. Spend a little time to spell out your goals, how you'll meet them, and the role of each investment. This is an enormous help in figuring out how to get to your goals and how to adapt along the way. Make a little plan, and your day-to-day investment decisions will become easier and less stressful.

Mistake 6 | Failing to write down your reasons for buying and selling.
Once you've got your plan, spell out why you own each investment and what would lead you to sell. For example, you could say that you own a focused equity fund as a long-term 20-year investment for its manager and its moderate costs. You'd sell if the manager left, costs were raised, or asset bloat forced a change in strategy. If you have doubts about the fund in the future, you can turn to that document when you may well have forgotten what the draw was in the first place.

Mistake 7 | Ignoring costs.
Expense ratios matter across the board. Most of the best managers work for low-cost funds. So, don't listen to the siren song of a high-cost mutual fund or hedge fund. Results won't live up to expectations. Expense ratios are the best predictor of future performance.

Mistake 8 | Making things needlessly complex.
This one comes courtesy of Christine Benz, Morning¬star's director of personal finance: Wall Street works overtime to sell the message that investing is complicated, messy stuff that you couldn't possibly undertake on your own. Is it any wonder that so many investors are paralyzed with fear and indecision? True enough, there are a handful of investors who have delivered tremendous returns by using swash¬buckling investment strategies and zooming in and out of arcane investments. For the rest of us mortals, though, buying and holding a portfolio composed of plain-vanilla stocks and bonds—with perhaps a dash of a "diversifier" such as commodities or real estate—is more than adequate to help us reach our goals. That's

also the kind of portfolio that you can easily manage yourself. By building a sturdy, streamlined portfolio, you'll have fewer moving parts to monitor.

Mistake 9 | Not understanding the risks.
Narrowly focusing on recent returns can blind investors to risks. If a fund has a long track record, you can easily get a handle on risk by looking at annual returns. In a bad year, the stock market can lose 30% or more. In a bad three-year period, it can lose 60%. It's reasonable to assume that nearly any stock fund can do at least that badly. This is why stocks are for 10- or 20-year time horizons or longer. If you know that going in, you stand a much better chance of earning a healthy return. Most bond funds can lose 5% or 10% in a year. If they have long maturity or own mostly junk-quality bonds, you can double those losses or more.

Mistake 10 | Not diversifying properly.
The 2008 bear market punished financials the most, while energy fared best. Large growth got crushed in 2000-02, and small-value stocks as well as bonds held up like champs. Every down period is different, so be sure to diversify between stocks and bonds, between foreign and domestic, and among sectors. The key is to have meaningful exposure to a lot of areas and to build up your core.

Mistake 11 | Not saving enough.
I'd encourage you to preach the benefits of early saving to relatives and friends in their 20s or 30s. If they make regular contri¬butions to their 401(k) and IRA accounts, reaching their goals will be quite manageable. If they don't, they better make a killing or they'll be behind the eight ball.

Mistake 12 | Failing to rebalance.
My 401(k) plan has a tool that automatically rebalances my investments for me. When the markets really move, your portfolio can go off-kilter and mess up your nicely laid plan. Rebalance yearly so that you'll be buying low and selling high.

Mistake 13 | Failing to factor taxes into portfolio decisions.
Like expenses, taxes play a huge role in your long-term success, but they're no fun. So, a lot of people ignore them in the hopes that their funds will make such big returns that taxes won't matter. There's a better way to think about it. Simply putting less-efficient investments in tax-sheltered accounts and more-efficient ones in taxable accounts will pay off in a big way. In addition, when you're shopping for a new fund for a taxable account be sure to look for those that should be efficient, such as tax-managed funds, index funds, low-turnover actively managed funds, and, of course, municipal-bond funds.

Mistake 14 | Not building up a sufficient money market position.
Benz recommends that you have six to 12 months' worth of living expenses in a money market account. There's no substitute for money market funds. This emergency stash is vital in case you lose your job or have another emergency, such as unexpected home repairs. In addition, it will make market downturns less stressful.

Mistake 15 | Ignoring costs in money market funds.
When interest rates rise, many fund companies and brokerages will resume charging high expenses on money market funds because investors don't pay attention. So, go with Vanguard or Fidelity or someone else who charges low costs to manage your cash.

Mistake 16 | Failing to look at the big picture across accounts.
Roger Ibbotson argues: Investors tend to view each investment and each account—401(k), IRA, college-savings account, etc.—in isolation rather than in aggregate. Trying to make every investment a winner can throw off the overarching asset allocation. It can also lead an investor to chase hot stocks, trade excessively, and sell at the wrong time. If all of an investor's accounts and individual investments are up at the same time, he should be alarmed rather than proud. It's a sign that he may be under-diversified and taking on too much risk.

Mistake 17 | Misreading your own abilities.
People who treat gambling addicts say that it's the big winning bet that hooks gamblers. They get high and want to repeat that high. Fund investors can be a little like that. They remember that one time they accurately called the direction of the market or picked a sector fund, and they forget all the times their calls were off. Go back over your past investments. See what you do well, and figure out a solution for the areas where you didn't do well. Maybe your individual stock picks aren't that great overseas, so you should buy a foreign fund. Maybe your bond fund blew up, so you should change the way you pick bond funds and tone down the risk.

Mistake 18 | Focusing on the fund instead of the manager.
The fact that previous managers did well or poorly is rarely relevant unless it reflects institutional strength or weakness. Examine the current manager's record.

Mistake 19 | Ignoring the fund company behind the fund.
You may like a fund, but if the fund company has mostly lousy investors, a record of sticking it to fundholders, or both, you may pay the price in the end. Over a long time horizon, bad things happen to good funds at bad fund companies and mediocre funds at the best fund companies are more likely to turn things around.

Mistake 20 | Worrying about daily ups and downs.

Don't get stressed watching business TV or tracking the market online. Those activities are exciting and often informative but not always helpful for long-term investors. Reporting on the markets, whether online, in print, or on TV, requires putting a lot of experts on to make predictions. If they were honest and said they didn't know what would happen the next week but that you should buy and hold, no one would watch. All those ups and downs have no bearing on your long-term goals. Warren Buffett advocates buying stocks you feel so strongly about that you wouldn't care if the stock market took a two-year holiday. The same goes for funds. Buy them and tune out the noise. M