

How to Manage Your Financial Risk

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Financial security is something everyone is after. But economic instability, job cuts, and Wall Street losses all make for a worrisome environment.

In times like these it is critical to minimize risk and maintain a measure of financial safety. This means analyzing expenses, seeking diversification, and scrutinizing spending.

What are some things you can do to limit risk? How can you cut unnecessary spending? Are you diversified enough?

This guide was created to help investors answer those questions.

Are You Adequately Insured Against Risk?

By Christine Benz, Director of Personal Finance and Editor of *Morningstar PracticalFinance*

At Morningstar, we firmly believe that the best investors are as attuned to the risks they're taking as they are to the money they're making. For that reason, we've long preached the importance of having an appropriate stock/bond mix given your time horizon, the value of having durable holdings at the core of your portfolio, and the folly of dabbling in overly narrow, risky investments. We've often gotten guff from our readers for our caution, particularly when the market is going up. But we believe that Warren Buffett had it right when he said that the first rule of investing is to not lose money, and that rule number two is to not forget the first rule.

At times like these, it's also important to anticipate financial risks that might arise. Here's an overview of some of the key risk-management questions to consider amid the ongoing drumbeat of bad economic news.

Are You Protected Against Identity Theft?

Consumers have, thankfully, become much more attuned to the issue of identity theft. However, given the trying economic climate, I think it's safe to assume that identity theft could pick up in the months ahead. You can't be too careful about security when conducting transactions online, and you should get in the habit of shredding documents that include identifying information. (I'm admittedly paranoid, but I shred anything that comes to my house with my name on it.)

Do You Have Adequate Insurance?

When making insurance decisions, one of the best pieces of advice is to not insure yourself against

risks you can afford to cover. For example, if you have ample savings, you're not going to be sunk if your computer goes kaput and you need to buy a new one. (Sorry, extended-warranty sellers at Best Buy.) On the flipside, you'll definitely want to insure against bigger, more costly risks. For that reason, you'll obviously want to have coverage for your home and autos, as well as good medical coverage. Also look into the following types of coverage.

Life Insurance: If you're still working and have dependents, your largest asset is your own ability to produce income in the future. Thus, it's essential that you have adequate life-insurance coverage. And if your spouse stays at home and cares for the kids, you may also want to investigate life insurance for her/him. Life-insurance agents may disagree with me, but term insurance is often the most effective (and certainly the most cost-effective) solution for many individuals. If an insurance agent recommends a more permanent type of policy, make sure you thoroughly understand the reasons why he or she finds this type of coverage preferable to a term policy.

Disability Insurance: One third of Americans between the ages of 35 and 65 will become disabled for more than 90 days during their working careers. If you couldn't do without your income for an extended period of time, it's imperative that you purchase disability coverage. Your employer may offer cost-effective coverage; sign up to pay for it using after-tax dollars, meaning that your benefits will be tax-free.

Umbrella Policy: If you're a worrywart like I am, you'll find that personal liability insurance (an "umbrella" policy) is one of the most cost-effective ways to purchase peace of mind. These policies usually sit on top of your homeowners and auto policies, and cover you in case you're sued for an accident that occurs on your property. If you have contractors, housecleaners, babysitters, or dog-walkers on your property—and even if you don't—an umbrella policy is a must.

Long-Term Care Insurance: Not everyone needs long-term care insurance. Those with a lot of assets may be able to cover their own long-term care costs, and those with small portfolios may be covered by Medicaid. If you're over 45 and fall somewhere in the middle of that spectrum, however, you should investigate long-term care, because the costs of nursing home or in-home care can quickly gobble up your nest egg. I favor the policies that include inflation protection, though you'll pay more for that type of coverage.

A version of this appeared in a Morningstar.com Improving Your Finances article on Jan. 29, 2009.

How to Set Up an Emergency Fund?

By Morningstar Analysts

Do You Have an Emergency Fund?

One of the fastest ways to start down the path of financial ruin is by not having a cushion to protect yourself against unanticipated events, such as losing your job, or unexpected expenses like home and auto repairs or medical bills. For that reason, conventional financial-planning wisdom is to put three to six months' worth of living expenses in a highly liquid account such as a savings account, CD, or money market fund.

If you find yourself living paycheck to paycheck or scrambling to make minimum payments on credit cards, then probably two things are happening: You haven't committed to a budget and you probably don't have an emergency fund in place.

Budgeting gets a bad rap most of the time, but it can be liberating in a sense. By going through the detailed process of seeing where your money goes, you can take control of how you're spending your hard-earned dollars.

Use the page provided in this booklet or any type of budgeting spreadsheet to tally up your expenses. If you're not happy with where your dollars are going, take action to reallocate how much you spend per category.

What's an Emergency Fund?

An emergency fund is a money market or savings account in which you keep a specified amount of money to cover expenses. You don't touch this money unless it's a real emergency.

Setting up an emergency fund is the first step toward building a solid financial plan. Once you've established your emergency fund, you will have a cushion that can protect you from financial troubles such as not being able to pay a bill or that can cover expenses if you are out of a job.

How Much Should You Keep in the Emergency Fund?

The amount you hold in your emergency fund will vary over time. At first, aim to keep enough to cover three months' worth of expenses. If you are used to spending every dime, it will take perseverance to tuck away money from each paycheck to stockpile your emergency fund. But it's well worth it. When you get this money saved, you should give yourself a pat on the back because you've just taken the first step toward financial independence. Just the fact that you are now saving on a regular basis is a financial milestone.

The general rule of thumb on how much should be in an emergency account is three to six months' worth of expenses. Given the current economic climate, however, Morningstar recommends building up a more generous savings cushion—six months' to a year's worth of living expenses, if you can swing it. This is particularly important if you are a higher-income earner, because it usually takes longer to find higher-paying jobs than it does those that pay less, or if you have any reason to believe that your job is in peril.

But take this one step at a time: Once you've squirreled away enough to cover three months' worth of living expenses, work to get to the

six-month mark. This generally happens over time as your salary increases.

How Do You Calculate How Much to Save?

One easy way to know just how much you are spending is to take your take-home pay and subtract how much you are saving. The rest is how much you are spending. Multiply that by the number of months you want to cover in your emergency fund.

For example, let's say I make \$50,000 in gross pay (no taxes or other amounts withheld). After taxes and other deductions, my take-home pay would be about \$40,000 a year or \$3,333 a month. To cover three months' expenses, I would need to save \$10,000 in this example. For six months, it would be \$20,000.

If you are serious about taking this important step, figure out exactly how much you can save each month and how long it will take to accumulate your target amount. In the above example, an individual looking to accumulate three months' worth of expenses in the next year would need to save about \$830 a month to amass \$10,000.

Should You Use a Home Equity Line of Credit as a Part of Your Emergency Fund?

Those of you with higher salaries and therefore greater emergency-fund requirements may choose to keep \$25,000 to \$50,000 in a money market fund and use a home-equity line of credit for any additional amounts needed to cover up to a year's worth of expenses. Just make sure you have a healthy amount of cash saved in very liquid

accounts because you wouldn't want to risk losing your house if you couldn't make a payment on your line of credit.

A version of this appeared in a Morningstar.com Improving Your Retirement article on March 13, 2009.

101 Ways to Cut Expenses

By Sue Stevens, CFA, CFP, CPA

- 1** Use the public library to check out movies or books for free.
- 2** Use the Internet to comparison shop.
- 3** Watch out for shipping costs when shopping online.
- 4** If you see something in a catalog that you want to buy, wait a week before ordering to see if you still really want it.
- 5** When traveling, look online for ideas and/or coupons before you go. Once on site, ask the locals for low-cost favorite spots, a la Rachael Ray.
- 6** Try a vacation at home. See and do the things you've always meant to do and save on hotel costs. The holidays are a perfect time to enjoy local festivities.
- 7** Send free e-cards and save on postage.
- 8** Give your time or services instead of "things" for gifts.
- 9** Go gray. If you hate sitting with gloppy color on your head and paying an arm and a leg for the privilege, you should know that as the baby boomers age, gray is "in."
- 10** If you own a house, shift your higher-rate credit card debt to a lower-rate line of credit. Deduct the interest on your tax return.
- 11** If you own a house, use a home equity loan to pay off auto loans. The interest is tax-deductible.
- 12** Pay your mortgage payment biweekly instead of monthly—you'll save on interest costs and pay off your mortgage sooner.
- 13** Pay extra premium payments when paying your mortgage. As above, you'll save interest payments and be able to pay off your mortgage sooner.
- 14** Pay cash when possible—psychologically it's harder to spend cash than it is to use credit cards, and you'll save on interest charges.
- 15** Set up one checking account for regular recurring expenses and another for bigger-ticket items. (Buy only if you've saved enough.)
- 16** Check with state or federal governments to see if you have money owed to you. To find out more about claims in your state, go to the National Association of Unclaimed Property Administrators' Web site.
- 17** If you've inherited an IRA, understand how to stretch out the tax deferral by taking the correct minimum required distribution.
- 18** Don't get divorced.
- 19** Quit smoking.
- 20** Save all your change and use it to buy gifts next year.
- 21** Go to matinee movies instead of movies at night.
- 22** Stop buying clothes that are "dry clean only." Learn to iron.
- 23** Plan parties where everyone brings something.
- 24** Have cocktails at home and then go out; have dessert at home.
- 25** Order vegetarian when you're out.

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- 26** Look up phone numbers in the phone book instead of paying for directory assistance.
 - 27** Sell stuff you don't need or use anymore on eBay.
 - 28** Shop resale shops or estate sales.
 - 29** Shop the clearance racks.
 - 30** Make your own greeting cards on a computer.
 - 31** Fill prescriptions with the generic form of the drug.
 - 32** Plan your purchases—avoid impulse buying.
 - 33** Use public transportation.
 - 34** Track your spending. If you write it all down, you'll probably spend less. And you'll know exactly where your money goes.
 - 35** Use your senior discount (if eligible). Go to the AARP Web site for information about member discounts and services.
 - 36** Skip paying cab fare now and then. Walk or take the bus.
 - 37** Don't buy mutual funds just before capital gains distributions.
 - 38** Use a budget—especially for items like gifts.
 - 39** Compare rates for cable and satellite. Go with the less expensive option. Sign up only for the channels you know you'll watch.
 - 40** Consider buying a certified pre-owned car instead of a new one.
 - 41** Don't renew subscriptions to publications you don't have time to read.
 - 42** Don't watch so much TV. You won't see all the ads and be as tempted to buy. Take a walk instead or play with your kids.
 - 43** Make IRA contributions early in the year to take advantage of additional months of tax deferral.
 - 44** Lock in a fixed mortgage rate so your interest rate can't increase to a point you can no longer make your house payments.
 - 45** Use ATMs only when you won't be charged service fees.
 - 46** Consider dropping your land line phone at home. Your cell phone may be all you need, and some come with free long distance services.
 - 47** Give up expensive health club memberships. Learn to exercise outdoors, at home, or through the park district. Or join the YMCA.
 - 48** With the high cost of oil, those hybrid cars are looking more attractive all the time. Check out the Hybrid Car Guide for more.
 - 49** Wait a little longer between manicures (try doing one yourself!), massages, or highlights, and try a local training school.
 - 50** Play golf less often, look for tee times when rates are reduced, or play at lower-cost public courses.
 - 51** Pay off your credit cards monthly and avoid paying interest.

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- 52** If you must charge, switch to a no-fee or low-fee credit card.
- 53** If your house down payment was less than 20%, cancel your private mortgage insurance once your mortgage balance is 80% or less of your home's value.
- 54** Check your credit history. Go to AnnualCreditReport.com and make sure everything is accurate. Good credit may mean lower interest charges.
- 55** If you have a tendency to "bounce" checks, deduct a "cushion" from your balance. Then if you accidentally let your balance go below zero, you'll hit that cushion instead of paying fees for insufficient funds.
- 56** Participate in company retirement plans to save on taxes. Your taxable income will go down and you'll defer taxes to the future.
- 57** Take advantage of your employer match in your 401(k) or other retirement plan.
- 58** Don't take a loan from your 401(k) plan—you'll save on double taxation of that repaid interest.
- 59** Take advantage of company-sponsored reimbursement plans. If your company sponsors free retirement advice, take advantage of it.
- 60** Talk to financial planners at no cost. Look for newspaper money shows or local events where this service may be offered.
- 61** Take advantage of free health screenings at work (if offered).
- 62** Switch to an HMO from a PPO for health insurance.
- 63** If self-employed, consider switching health insurance plans to high-deductible plans to take advantage of HSAs.
- 64** Take advantage of medical prescription drug cards.
- 65** Get multiple quotes on insurance. It pays to shop around.
- 66** Raise the deductible on your homeowners insurance and car insurance policies.
- 67** Increase the waiting period to six months or longer on your long-term care insurance.
- 68** Review life insurance premiums. Can the dividends pay the premium instead of purchasing more coverage?
- 69** Buy term instead of whole life or universal life insurance.
- 70** If considering moving or retirement, look into places where the cost of living and/or state tax rates are cheaper.
- 71** Keep track of your cost basis on investments to save money on taxes when you sell an investment.
- 72** If you have a loss on your Roth IRA (the current balance is less than what you contributed), consider taking out the balance and claiming a deduction for the loss on Schedule A of your tax return.
- 73** Avoid paying penalties on retirement distributions by waiting until you're over age 59 1/2 to make withdrawals. Start required minimum distributions from traditional IRAs when you're age 70 1/2.

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- 74** Do a 1035 annuity exchange to a company with lower expenses.
- 75** Put investments that generate ordinary income in tax-deferred accounts.
- 76** Use tax-exempt bonds in taxable accounts.
- 77** Put investments that generate capital gains or dividends (both generally taxed at lower rates than ordinary income) in taxable accounts.
- 78** Pay attention to the expense ratios on mutual funds you buy.
- 79** Consider using exchange-traded funds.
- 80** Pay attention to mutual fund brokerage fees.
- 81** Use prior-year capital-loss carryforwards to net out realized capital gains. You'll pay less tax.
- 82** If you have stock options, consider holding the shares after exercise for at least one year. You'll pay capital gains tax on the appreciation when you sell.
- 83** Cook in bulk and freeze.
- 84** Turn down your home thermostat a couple of degrees in the winter.
- 85** Only do full loads of laundry and fill the dishwasher before running it.
- 86** Get a roommate and share expenses.
- 87** Investigate phone service via the Internet.
- 88** Use regular gas instead of premium.
- 89** Cut back on eating out.
- 90** Be a smart grocery shopper—cut coupons, shop at discount stores, and stock up on sale items. Check out Costco or Sam's Club.
- 91** Buy energy-efficient appliances. They're cheaper in the long run.
- 92** Get rid of "add on" services with phone, TV, etc.
- 93** Keep up maintenance on cars. It may prevent costly future problems.
- 94** Get annual physicals to prevent costly future problems.
- 95** Wash your car at home and skip the car wash.
- 96** Pay bills online. Save postage.
- 97** Trade in your car with high insurance premiums for a car with lower insurance premiums.
- 98** Sign up for a Upromise credit card. A percentage of your purchases will go into a college savings fund for your children.
- 99** Do your own home improvements. Home Depot and Lowe's employees can walk you through what you need to know.
- 100** Bring your lunch to work or scout out the inexpensive places to buy lunch. Look for inexpensive items on the menu, like soup.
- 101** Cut back trips to Starbucks or other premium coffee shops.
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- A version of this article appeared in the September 2005 issue of *Morningstar PracticalFinance*.

Is Your Mutual Fund Taking too Much Risk?

The subprime mess has hurt lately, but keep the big picture in mind, too.

By David Kathman, CFA

I took a look at how the subprime-mortgage mess was affecting various types of mutual funds and how it's likely to affect them in the future. Such blowups highlight the facts that investing comes with risks and that some investments are riskier than others. Identifying those risks, and figuring out how much you're willing to tolerate, is one of the most important aspects of long-term investing.

Unfortunately, there's no single definition of risk that works for everybody, but there are some key measures that will usually give you a good approximation. They're not perfect—there are often hidden risks lurking—but they're certainly better than guesswork. Here are some of the most useful ways to look at mutual fund risk.

Backward-Looking Risk Measures

The world of finance is replete with measures that try to gauge how risky an investment has been in the past. In this context, risk is often equated with volatility, and the most common way to measure the volatility of a mutual fund (or any portfolio) is standard deviation. As Morningstar calculates it, this measures how widely the fund's monthly returns have varied over some period of time, usually three, five, or 10 years. If monthly returns have been very consistent, the standard deviation will be low, while if they have been all over the map, the standard deviation will be high.

One problem with standard deviation is that it's essentially meaningless without a context. Some types of funds are inherently more volatile than others, so any given fund's standard deviation can

only be reasonably compared with those of its peers. Sector funds are more volatile than diversified stock funds, which in turn are more volatile than bond funds, and within each of these broad groups there's a lot of variation. As of Dec. 31, 2007, the highest five-year standard deviation in the short government bond category belonged to **Federated U.S. Government 2-5 Year** FIGTX at 3.18. In contrast, the precious-metals fund with the lowest standard deviation was **Vanguard Precious Metals and Mining** VGPMX, at 22.64—more than 7 times as much.

Another potential problem with standard deviation is that it treats big gains and big losses (in industry parlance, upside and downside volatility) the same. But most investors are a lot more concerned with downside volatility—the possibility that a fund will lose money or greatly underperform its peers.

One measure that takes this difference into account is the Morningstar Risk score, which is part of the Morningstar Risk-Adjusted Return that helps determine a fund's Morningstar Rating. The details are rather complicated, but basically this measure uses a "utility function" that penalizes downside variation more than it rewards upside variation. Each fund's Morningstar Rating page on Morningstar Investment Research Center shows its Morningstar Risk relative to its category, ranging from "high" (the riskiest 10%) down to "low" (the least risky 10%). For example, the page for **Vanguard Precious Metals and Mining** VGPMX shows that its Morningstar Risk is among the lowest in its category, even though (as we saw above) its standard deviation is high in absolute

terms. The fund has shown a lot of variation in its returns but has done a better job than its peers of avoiding big losses.

Portfolio Risks

Both standard deviation and Morningstar Risk are backward-looking risk measures; that is, they're based on how a fund has performed in the past. That can certainly be useful, but most investors (and potential investors) are more interested in what a fund is likely to do going forward. Obviously we can't know for sure how a fund will perform in the future, but it's still possible to look at its strategy and current portfolio and get some idea of what kinds of potential risks a fund is likely to face.

One factor to keep an eye on is concentration. Funds that concentrate their assets in relatively few holdings—say, fewer than 30 for stock funds—can suffer in the short term if just one or two of those holdings run into problems. Such concentration risk is separate from standard deviation and Morningstar Risk, and it's often present in funds that we like quite a bit. For example, the **Jensen Fund** JENSX has compiled a very good long-term record with a concentrated portfolio of about 25 stocks. Its standard deviation and Morningstar Risk are very low because of the managers' long-term focus, but its concentrated nature has made performance quite streaky, so that it has typically ranked near either the top or the bottom of the large-growth category.

A related type of risk arises from sector concentration, especially when these are volatile sectors

such as technology. The most obvious example of this is sector funds, which focus on a single sector, but there are also quite a few funds that are nominally diversified but still pile into one or two sectors that can wreak havoc with returns. An extreme example of this is **Van Wagoner Emerging Growth** VWEGX, a small-growth fund that has about 80% of its portfolio in technology stocks. That huge tech stake led the fund to an eye-popping 291% return in 1999, but this was followed by ugly double-digit losses in the subsequent bear market, during which the fund lost nearly 90% of its value.

Yet another type of risk to watch out for in stock funds is country or geographical concentration, especially concentration in relatively risky areas such as emerging markets. Emerging-markets stocks have been red-hot in recent years, and funds with a lot of emerging-markets exposure have done very well. **Janus Contrarian** JSVAX, for example, has compiled one of the large-blend category's best records over the past five years, and one of the reasons has been its outsized weighting in foreign stocks, including significant exposure to India and other emerging markets. That exposure has also made this one of the category's most volatile options and hurt the fund temporarily in 2006 when emerging markets tumbled in the spring. It's still a pretty good fund overall, but it could take a hit if and when overseas stocks end their run of outperformance.

These examples have all involved equity funds, but bond funds feature similar portfolio-based risks. Until the subprime-mortgage crisis hit, high-yield

bonds and emerging-markets bonds were on a great multiyear run, much like emerging-markets stocks, and bond funds with a lot of high-yield exposure relative to their peers generally did very well. Within the intermediate-term bond category, for example, the best-performing funds from 2003 through 2006 were mostly those with lots of exposure to such risky bonds, such as **Delaware Diversified Income** DPDFX and **Federated Bond** ISHIX. While those great recent returns may have looked attractive and even benign at first glance, there was plenty of risk lurking in those portfolios, as the subprime mess illustrated all too clearly.

Operational Risks

Another group of risks worth touching on for mutual fund investors are operational risks, which have to do with how a fund is run. For example, the risk that a manager might leave a fund is certainly something to consider, and that risk is much higher in some cases than in others. Fidelity sector funds are well-known for high manager turnover (though they've gotten better recently), while shops such as Dodge & Cox and Longleaf have managers who have been in place for decades. The risk of new or higher fees is also worth considering, and here, too, some fund shops are much better than others—Vanguard is well-known for keeping expenses low, while Gabelli, to give one example, is not.

Asset bloat is another operational risk to consider; if a fund's asset base gets too big, it becomes harder to beat a benchmark or a peer group. The American Funds are perhaps the most prominent example: Many of these funds have become

behemoths, with **American Funds Growth Fund of America** AGTHX tipping the scales at more than \$190 billion. Although performance has mostly continued to be good—Growth Fund of America did trail the large-growth category in 2007, but has come back strong this year—there's a real risk that all those assets will make it harder to stand out going forward.

What You Can Do

There are a number of ways that you can check the funds in your portfolio (or those you're thinking of buying) for these various types of risk. Look up any fund on Morningstar Investment Research Center and go to the tabs on the left side of the page. As we saw earlier, under the Morningstar Rating tab you'll find the fund's Morningstar Risk over the trailing three, five, and 10 years, and the Risk Measures tab will show you its standard deviation, along with some other measures that we haven't discussed here, such as the Sharpe ratio. For the forward-looking risks, click on the Portfolio tab and scroll down to the sector weightings, where you can see whether the fund is over- or underweight in various sectors relative to its category peers. And, it's always a good idea to look at the Analyst Report (under the Analyst Research tab), which will generally discuss any significant risks to look out for. Our Stewardship Grades can also give you an idea of a fund's operational risks, especially in the corporate-culture section.

In all this, it's important to remember that no fund's risk should be looked at in isolation. A fund that might look very risky all by itself could be a

good fit in certain portfolios. For example, a fund with lots of technology holdings could complement a portfolio with heavy value leanings, and an emerging-markets fund could help diversify a portfolio consisting entirely of domestic stocks. The Portfolio X-Ray Tool on Morningstar Investment Research Center can break down a portfolio by sectors, asset classes, and other valuable detailed analysis. You might find that you're taking on risks that you didn't realize, such as a big weighting in technology stocks, or you might find that there's room in your portfolio for more risk. When all is said and done, it's important to remember that even the best fund managers can have streaky short-term performance, so it's best not to get too hung up on consistency.

A version of this article appeared in a Morningstar.com The Short Answer article on Feb. 5, 2008.

Why Diversification Still Matters

Although tested mightily in the bear market, diversification remains a solid idea.

By David Kathman, CFA

At Morningstar, we've long been advocates of diversification in investing. A diversified portfolio is less risky than one that's concentrated in one area of the market, because different parts of the portfolio will tend to do well at different times, thus smoothing returns over time.

For example, a portfolio invested entirely in large-cap growth stocks would have gained more than 30% annually from 1995 through 1999 but would have lost around 20% annually from 2000 through 2002. Had that portfolio included 30% in bonds, that bond position would have tempered the portfolio's gains in the late-90s' bull market but also would have reduced its losses in the subsequent stock market crash, when the Lehman Aggregate bond index gained an average of 10% a year.

A lot of traditional investing ideas, including the value of diversification, were tested mightily in the brutal bear market of 2008. In the early stages of the current crisis there were still some bright spots, such as emerging-markets and commodity stocks, but by the second half of 2008 there was almost nowhere to hide. Domestic stocks, foreign stocks, commodities, and even bonds posted significant losses, with only Treasury bonds, perceived as one of the only remaining safe havens, gaining ground. It was enough to make some people wonder whether diversification is even worth the bother, if everything is just going to go down.

The second half of 2008 was certainly painful for just about all investors, but it would be a big mistake to extrapolate too much from this very unusu-

al period, as noted by asset-allocation expert Robert Arnott. While diversification generally isn't as effective as usual in a broad-based market crash like that of 2008, it certainly still helps, and last year's anomalous market conditions are not going to last forever.

Diversifying by Asset Class

For example, consider the most fundamental type of diversification, building a portfolio with exposure to asset classes such as stocks, bonds, and cash (sometimes with other asset types such as gold or real estate thrown in). This type of diversification is the most important part of bringing a portfolio in line with a given investor's risk tolerance and time horizon. In general, the greater a portfolio's stock weighting, the greater the risk; adding bonds or cash will tend to make it less prone to extremes on both the upside and the downside, as in the example we saw above. The closer you are to needing the money, the more bonds and cash you should have.

Now, it's true that many bonds have lost ground along with stocks over the past year, and some bond funds have blown up in spectacular fashion. Even so, investors who held some bonds last year along with stocks lost significantly less than those who were 100% in stocks. For example, **Vanguard 500 Index** VFINX, which tracks the S&P 500, was down 37% in 2008. (And that was a better result than most funds in the large-blend category.) A portfolio with 80% in Vanguard 500 Index and 20% in **Vanguard Total Bond Market Index** VBMFX would have lost 29%, while putting 40% of this portfolio in the bond fund

would have reduced that loss to 20%—still not fun, but significantly less painful.

In the current market environment, it might be tempting to go all the way and put your portfolio entirely in cash, which didn't lose anything last year, or Treasury bonds, which posted substantial gains. The problem is that stocks are apt to improve eventually, and if you're positioned ultra-conservatively you're likely to miss out on a lot of gains when that happens. If all you're concerned about is preserving capital, that might be OK, but most investors—even many retirees—want to strike a middle ground between capital preservation and potential gains. Indeed, there are already signs that things are shifting: High-yield bonds, which tanked last year, are the best-performing bond category so far in 2009, while Treasury bonds have fallen significantly after last year's big runup.

Sector and Geographical Diversification

Asset-class diversification is the key step in building an appropriate portfolio, but it's also important to consider diversification within asset classes, such as whether your stock investments are diversified across sectors.

The 2008 market environment appeared to test the notion that sector diversification matters: While it appeared that certain sectors, such as energy and basic materials, were bucking the market's downward trend in the first half of the year, collapsing commodity prices in the second half caused those stocks to plunge. There was seemingly no place to hide as all 12 Morningstar stock sectors suffered double-digit losses for the year.

However, as with asset classes, it would be a mistake to conclude from all this that sector diversification doesn't matter. For one thing, some sectors have lost significantly less than others in the current downturn; the average health-care stock has lost about 13% over the past year, while the average financial stock has lost almost 40%. That doesn't mean that you should sell all your financial stocks and load up on health care, though; many mutual funds that tried to make such out-sized sector bets over the past year, such as **CGM Focus** CGMFX (which moved heavily into financials in the third quarter of 2008), got burned. The point is that the various sectors still don't move in tandem, but it's virtually impossible to predict which will do best going forward, so it's generally a good idea to spread things out a bit.

It's a similar story with geographical diversification. In the early stages of the current downturn, emerging markets such as China and India continued rising even as the U.S. market was sputtering, leading to a lot of talk about how those markets were "decoupling" from the United States economy. However, everything went down in 2008, especially in the second half, with most international-stock fund categories falling 40% or more for the year, even more than domestic-stock categories.

That was certainly an ugly period for markets all over the world, but it was very unusual historically; markets have already started diverging again, and as with asset classes, they're sometimes doing so in unexpected ways. The worst-performing foreign-stock category in 2008, Latin America stock, is by far the best performer so far in 2009,

while the Japan-stock category, which held up well last year, has been among this year's worst performers. Diversification may not be the key reason to hold foreign stocks in your portfolio anymore—owning great companies domiciled overseas is—but geographic diversification is another step that can smooth out your portfolio's returns from year to year.

What We Do Know

Last year's market collapse, while painful in almost unprecedented ways, did not change the fundamental importance of diversifying your portfolio. It's true that diversification becomes temporarily less important in times of market panic like we experienced last fall, but those times don't last forever. Once markets recover, diversification arguably becomes more important than ever. It's very difficult to predict which areas of the market will lead a recovery, so betting heavily for (or against) one of them is risky business.

Of course, most investors are willing to take some risk, but it's important to be aware of how much you're willing to tolerate, and whether your portfolio is diversified appropriately for that level of risk. The Portfolio X-Ray Tool on Morningstar Investment Research Center allows you to input a portfolio and see how well diversified it is by asset class, sector, geographic region, and various other factors.

A version of this article appeared in a Morningstar.com The Short Answer article on Feb. 10, 2009.

Setting Up Your Budgeting Plan

When it comes to risk, nothing drives fear like a turbulent economy. One way to safeguard against overspending is to monitor your budget. However, that is much easier said than done. Often we don't realize how much we are spending on a daily, weekly, and a monthly basis.

The best way to help keep track of these is to write down your expenses. This will no doubt open your eyes as to where your money is going and where you can cut back on your spending.

On the following page is an example of a budgeting worksheet. Use this to keep track of your expenses or as a template to create your own version. In any case, we hope this will be a useful way to monitor your saving and spending habits.

Budget Worksheet

	Budget Amount	Actual Amount	Difference
Example: Dining Out	\$200	\$500	(\$300)
Income			
Wages and Bonuses			
Interest Income			
Investment Income			
Miscellaneous Income			
Subtotal			
Income Taxes Withheld			
Federal Income Tax			
State and Local Income Tax			
Social Security/Medicare Tax			
Subtotal			
Total Spendable Income			
Expenses			
Mortgage or Rent			
Homeowners/Renters Insurance			
Property Taxes			
Monthly Maintenance/Association Fees			
Home Improvements			
Home Expense Subtotal			
Electricity			
Water and Sewer			
Natural Gas or Oil			
Telephone (Land Line, Cell)			
Utilities Expense Subtotal			
Credit Cards			
Student Loans			
Other Loans			
Debt Payments Subtotal			
Insurance (Medical, Dental, etc.)			
Out-of-Pocket Medical Expenses			
Health Club/Fitness Dues			
Medical Expense Subtotal			
Groceries			
Eating Out, Lunches, Snacks			
Food Expense Subtotal			

	Budget Amount	Actual Amount	Difference
Example: Dining Out	\$200	\$500	(\$300)
Expenses (continued)			
Child Support/Alimony			
Day Care, Babysitting			
Family Care Expense Subtotal			
Car Payments			
Gas			
Auto Insurance			
Maintenance			
Other (Bus, Taxi, Tolls, etc.)			
Transportation Expense Subtotal			
Cable TV			
Computer Expenses			
Movies/Hobbies			
Sporting/Concert Events			
Subscriptions and Dues			
Vacations			
Entertainment Expense Subtotal			
Food			
Grooming, Boarding, Vet			
Pet Expense Subtotal			
401(k) or IRA			
Stock & Mutual Fund Investments			
College Savings Fund			
Savings Account			
Emergency Fund			
Investment & Savings Expense Subtotal			
Clothing			
Personal Hygiene Products			
Gifts/Donations			
Grooming (Hair, Nails, etc.)			
Other Miscellaneous Expenses			
Miscellaneous Expense Subtotal			
Total Expenses			
Surplus or Shortage	Total Spendable Income - Total Expenses =		



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