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How to Tune Up Your Portfolio During Market Uncertainty

Christine Benz
Director of Personal Finance & Retirement Planning
Morningstar, Inc.
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Market performance: The really long view

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2006–21
Highest Return (%)	39.4	17.4	83.8	28.4	13.1	19.7	37.9	13.6	1.8	20.3	36.0	1.2	31.8	21.7	27.2	10.9
	16.2	–5.2	58.2	21.8	7.7	17.5	31.8	7.2	1.8	17.1	25.5	–1.7	26.0	18.8	27.1	9.1
	12.7	–22.2	37.7	16.8	5.0	16.5	22.0	6.9	0.7	11.8	22.7	–2.1	23.4	16.4	16.2	7.1
	10.6	–26.2	36.1	15.1	2.6	16.0	14.3	6.4	–1.4	11.3	15.0	–3.4	19.0	12.8	12.7	6.8
	8.6	–35.6	24.8	13.4	0.6	15.8	7.4	4.9	–1.8	11.2	14.7	–4.8	18.6	9.8	10.2	5.8
	6.7	–36.1	21.8	12.3	–2.6	12.4	–1.8	2.5	–4.5	8.6	7.5	–11.2	14.3	9.1	5.3	5.4
	5.2	–36.2	21.2	11.4	–11.9	12.0	–2.1	–0.8	–4.9	5.8	5.6	–12.1	14.2	9.0	0.0	4.6
	1.9	–43.0	18.9	10.8	–13.3	3.6	–4.6	–3.9	–13.3	3.4	2.1	–13.2	7.7	7.1	–1.6	4.5
Lowest Return (%)	–0.7	–53.8	–5.0	8.7	–18.6	–1.1	–9.5	–17.0	–24.7	1.2	1.7	–13.9	7.4	–3.1	–3.0	–2.6

- Small stocks
- Large stocks
- International-developed stocks
- Emerging-markets stocks
- Inter-term government bonds
- Inter-term corporate bonds
- High-yield bonds
- Commodities
- Moderate portfolio

2021 equity performance: Size explains a lot

Performance by Market Cap

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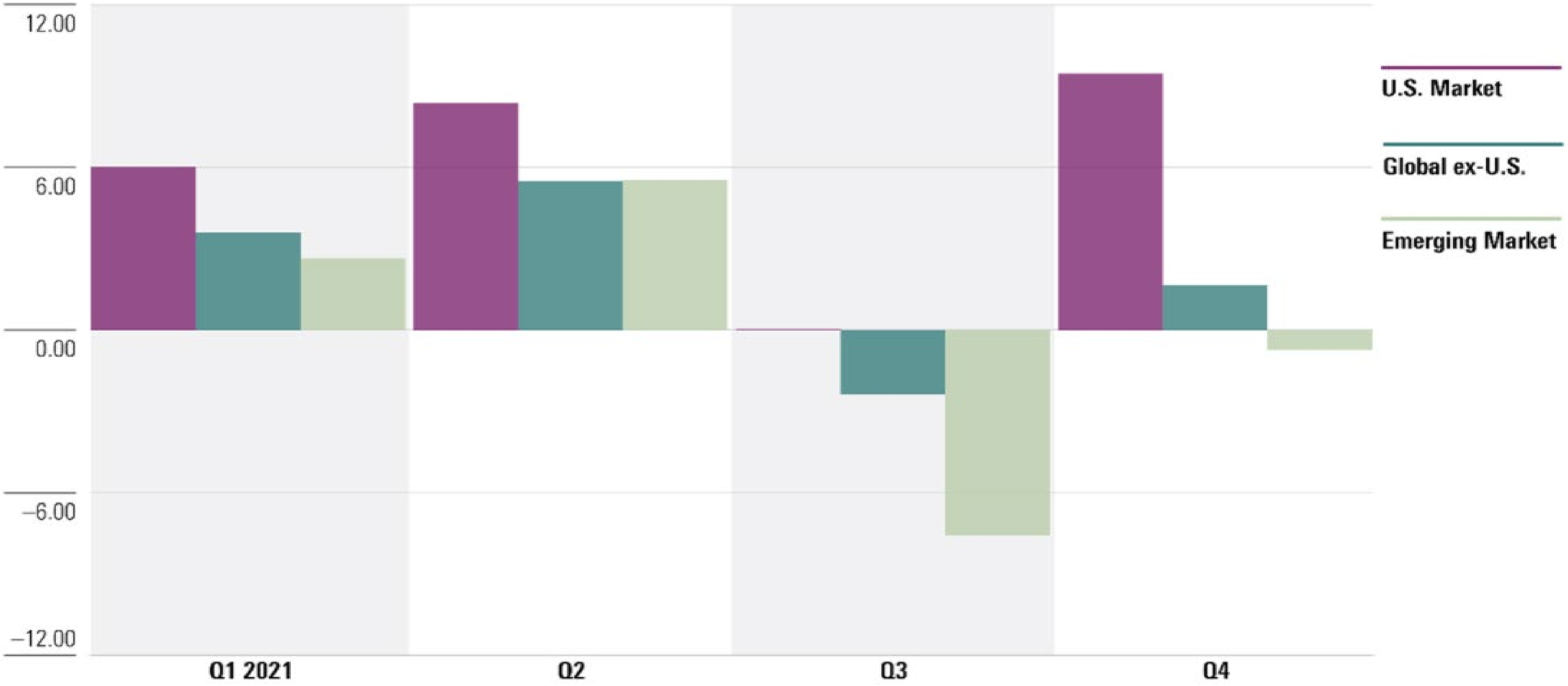
2021 equity performance: Value staged a comeback

	1-Year (1/1/2021-12/31/2021)	3-Year (1/1/2019-12/31/2021)	5-Year (1/1/2017-12/31/2021)	10-Year (1/1/2012-12/31/2021)
Large Value	26.08	17.40	11.41	12.06
Large Growth	20.46	28.85	21.75	17.12
Value-Growth Performance	5.62	-11.45	-10.34	-5.06
Mid-Cap Value	29.39	18.43	10.45	12.15
Mid-Cap Growth	13.20	27.15	19.03	15.17
Value-Growth Performance	16.19	-8.72	-8.58	-3.01
Small Value	31.68	18.35	8.88	11.31
Small Growth	11.12	24.77	17.33	14.68
Value-Growth Performance	20.56	-6.41	-8.45	-3.37

2021 equity performance: U.S. stocks beat non-U.S. (again)

Quarterly Returns



Source: Morningstar Direct.

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2021 bond performance: High-quality bonds struggle

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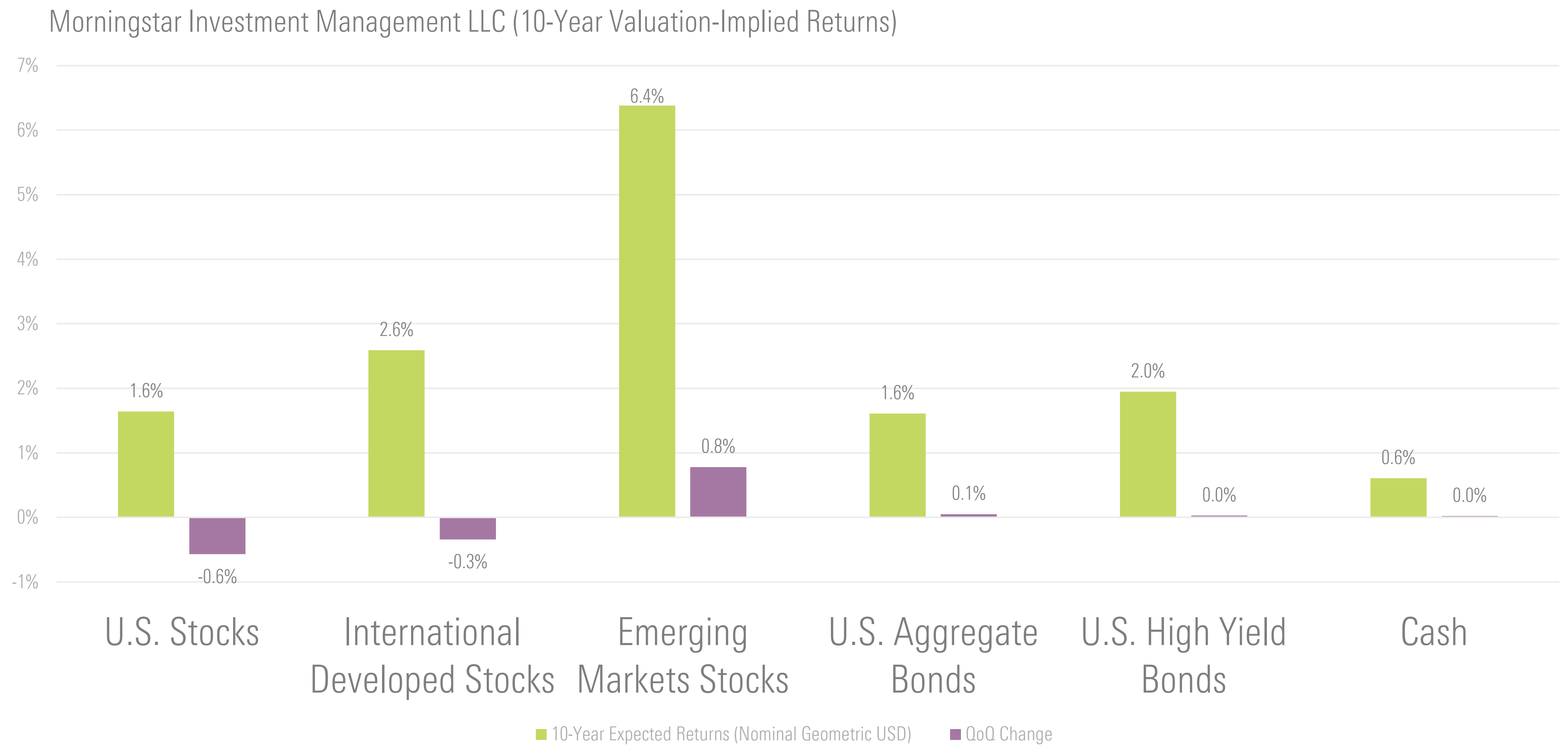
2021 bond performance: Yield spreads tighten

Strong past returns argue for sober expectations about the future



A 9-step portfolio tuneup

- Step 1: Ask and answer: How am I doing?
- Step 2: Check asset allocation
- Step 4: Evaluate adequacy of liquid reserves
- Step 5: Assess equity exposures
- Step 6: Assess fixed income exposures/interest-rate sensitivity
- Step 7: Evaluate inflation protection
- Step 8: Review individual positions
- Step 9: Make changes tax-efficiently

As you conduct your portfolio tuneup

- Remember that less is more: Annual, semi-annual, or quarterly at the most
- Stay focused: Employ a checklist to help you get in and out
- Progress from most important to less important variables
- Think about your long-term strategy, not just performance
- Take tax and transaction costs into account if changes are needed

Step 1: Ask and answer: How am I doing? (Accumulators)

- Thumbnail test: 15% current salary = annual minimum savings target
- Higher-income earners should target an even higher savings rate
- Some savings benchmarks to mark your way
  - By age 35: 2X salary saved
  - By age 45: 4X salary saved
  - By age 55: 7X salary saved
  - By age 65: 10X-11X salary saved (or 25X spending)

Step 1: Ask and answer: How am I doing? (Accumulators)

- For a more customized take on the adequacy of your investment accounts and savings rate, utilize a retirement savings calculator or seek help from a financial advisor
- Be sure to factor in:
  - Inflation
  - Reasonable return expectations, variability of returns
  - Taxes
  - The role of other income sources, such as pensions and Social Security

Step 1: Ask and answer: How am I doing? (Retirees)

- Step 1: Calculate anticipated portfolio withdrawal
    - Year 1 Withdrawal
    - Minus Income from Other Sources
    - Equals Required Portfolio Withdrawal
- Step 2: Calculate withdrawal *rate*
    - Required Portfolio Withdrawal
    - Divided by Total Portfolio Balance
    - Equals Withdrawal Rate

Step 1: Ask and answer: How am I doing? (Retirees)

- A very basic rule of thumb is that 4% with an annual inflation adjustment is a safe withdrawal rate for most
- For someone with an $800,000 portfolio:
  - Year 1 Withdrawal: $32,000
  - Year 2 Withdrawal: $32,960 (assuming 3% inflation)
- Our recent research suggests that new retirees be even more conservative
- 3.3% starting withdrawal rate for people with 30-year time horizons, balanced portfolios, 90% certainty of not running out

Step 1: Ask and answer: How am I doing? (Retirees)

Exhibit 9 Projected Starting Safe Withdrawal Rates, by Asset Allocation and Time Horizon

Equity Weighting %	10 Years	15 Years	20 Years	25 Years	30 Years	35 Years	40 Years
100	8.3	5.6	4.3	3.5	2.9	2.7	2.5
90	8.6	5.7	4.4	3.6	3.0	2.8	2.6
80	8.8	5.9	4.6	3.7	3.1	2.9	2.6
70	9.1	6.1	4.7	3.9	3.2	3.0	2.7
60	9.3	6.2	4.8	3.9	3.3	3.0	2.8
50	9.5	6.4	4.9	4.0	3.3	3.0	2.8
40	9.6	6.5	4.9	4.0	3.3	3.0	2.7
30	9.7	6.5	4.9	4.0	3.3	3.0	2.7
20	9.7	6.3	4.8	3.9	3.2	2.8	2.5
10	9.5	6.3	4.7	3.7	3.0	2.7	2.3
0	9.5	6.1	4.4	3.4	2.7	2.3	2.0

Source: Morningstar Direct. Data as of 12/31/2020.

Step 2: Check asset allocation

- Beyond how much you save and/or how much you withdraw, your asset allocation is the biggest determinant of how your portfolio behaves
- Morningstar's X-Ray tool a good starting point for gauging asset allocation
- Portfolio Manager enables you to X-Ray, as does Instant X-Ray (on Tools tab of Morningstar.com)

Step 2: Check asset allocation

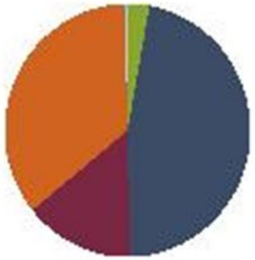
Tracking | My View | My Performance–beta | X-Ray®

Set This View as Default View

X-Ray Overview | X-Ray Details | X-Ray Interpreter | Stock Intersection

Print

Asset Allocation | Holdings Detail ››



	Long%	Short%	Net%
Cash	3	0	3
U.S. Stocks	47	0	47
Foreign Stocks	14	0	14
Bonds	35	0	35
Other	0	0	0
Not Classified	0	0	0
Total	**100**	**0**	**100**

Stock Style Diversification | Holdings Detail ››

Valuation

Size	Value	Core	Growth
Large	26	24	21
Med	6	6	7
Small	3	3	4

Not Classified 0.00%

Interest Rate Sensitivity

Credit Quality	Ltd	Mod	Ext
High	21	49	0
Med	17	0	7
Low	0	4	0

Not Classified 0.00%

Stock Sector | Holdings Detail ››

	Portfolio (% of Stocks)	S&P 500 (%)
Cyclical	**35.40**	**29.94**
Basic Materials	4.81	3.31
Consumer Cyclical	11.33	10.15
Financial Services	16.69	14.40
Real Estate	2.57	2.08

Stock Type | Holdings Detail ››

	Portfolio (% of Domestic Stocks)	S&P 500 (%)
High Yield	**5.47**	6.41
Distressed	**0.83**	0.42
Hard Asset	**11.54**	12.33
Cyclical	**44.87**	41.99
Slow Growth	**10.87**	11.99

Step 2: Check asset allocation

- Compare actual asset allocation to your target asset allocation
- No target asset allocation? Morningstar Lifetime Allocation Indexes and target-date funds can be a starting point
- Customize your asset allocation based on factors such as the following:
  - Your human capital (type of job, life stage)
  - Other assets (spouse's assets, taxable brokerage accounts, IRAs, etc)
  - Your time horizon until you'll need your money

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Step 2: Check asset allocation

- Plan to rebalance if position in a major asset class is 5 to 10 percentage points higher than target
- If it has been 5 years since last rebalancing, contents have shifted

Overall Asset Mix (% of Total)				
Stock/Bond Mix			60%/40%	72.5%/27.5%
U.S./International Mix			40%/20%	54.4%/18.1%
Growth/Value Mix			20%/20%	34.7%/19.7%

Source: Morningstar Direct. Data as of November 30, 2021.

Step 2: Check asset allocation (bucketer's version)

Bucket 1

For: Years 1 and 2

Holds: Cash

Goal: Fund Near-Term Living Expenses

Bucket 2

For: Years 3-10

Holds: Bonds, Balanced Funds

Goal: Income production, stability, inflation protection

Bucket 3

For: Years 11 and beyond

Holds: Stock

Goal: Growth

Sample in-retirement bucket portfolios ($60,000/y spending)

Bucket 1: Liquidity Portfolio for Years 1 and 2: $120,000

$120,000 in CDs, money market accounts/funds, other cash

Bucket 2: Intermediate Portfolio for Years 3-10: $480,000

$100,000 in Vanguard Short-Term Bond ETF BSV

$150,000 in Vanguard Short-Term Inflation-Protected VTIP

$230,000 in iShares Core US Bond Market IUSB

Bucket 3: Growth Portfolio for Years 11+: $900,000

$350,000 in Vanguard Dividend Appreciation VIG

$225,000 in Vanguard Total Stock Market Index VTI

$250,000 in Vanguard FTSE All-World ex-US VEU

$75,000 in Vanguard High-Yield Corporate VWEHX

Step 3: Evaluate adequacy of liquid reserves

- **Baseline amount if retired:**
  - 6 months' to 2 years' worth of living expenses
- **Baseline amount if working:**
  - 3 to 6 months' worth of living expenses
- **Other tips for setting your liquid reserves:**
  - Do not count: Residual cash in mutual funds, short-term bonds
  - Beware of notoriously low-yielding accounts (brokerage sweep)

Step 3: Evaluate adequacy of liquid reserves (retirees)

If retired and need to replenish cash reserves, consider the following sequence:

- See how far bond income and dividend distributions will take you for next 1-2 years
- Use rebalancing proceeds to deliver the additional income you need (for most retirees, this will mean trimming stocks right now; in other markets, maybe not)
- “Buffer” assets can reduce dependence on true cash (annuities, life insurance cash value, reverse mortgage)

Step 4: Assess equity exposures

- Some parts of the market have soared while other segments have performed less spectacularly
- Growth > Value
  - Morningstar U.S. Growth Index: 22.6% 5-year annualized return
  - Morningstar U.S. Value Index: 11.3% 5-year annualized return
- U.S. > Non-U.S. markets
  - Morningstar U.S. Market Index: 16.07% 5-year annualized return
  - MSCI EAFE Index: 9.0% 5-year annualized return

Step 5: Assess fixed income exposure/interest rate sensitivity

- The Fed's planned rate hikes put pressure on bond prices
- Among the hardest-hit bond types
  - Long-term bond funds: -3.6% YTD through 1/14
  - Long-term government bond funds: -2.5% YTD through 1/14
  - Emerging markets bond funds: -2.9% YTD through 1/14
- Fed has done a good job of telegraphing moves; near-term rate hikes already priced into bond market?

Step 5: Assess fixed income exposure/interest rate sensitivity

- Consider the following "duration stress test"
- The fund's duration minus fund's SEC yield = expected loss over one-year period if interest rates rose by 1 percentage point
  - Long-term government bond funds' average duration: 18 years
  - Long-term bond funds' average yield: ~1.7%
  - Duration of 18 minus 2% = ~16% loss if rates rose by 1 percentage point

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Step 5: Assess fixed income exposure

Lower-quality bonds offer higher yields, but w/higher correlation to stocks

Morningstar Category	3-Year Correlation Versus: Morningstar US Market Index	Morningstar US Core Bond Index
Bank Loan	0.74	0.11
Emerging-Markets Bond	0.74	0.29
High-Yield Bond	0.81	0.21
Multisector Bond	0.74	0.36

Source: Morningstar Direct. Data as of Dec. 31, 2021.

Step 6: Evaluate inflation protection

- Inflation (Consumer Price Index for All Urban Consumers) has been mild for decades but has been trending up very recently
- Most recent CPI-U reading: 7% (!)
- Inflation is the most worrisome for retirees, whose portfolio paychecks aren’t inflation-adjusted

Step 7: Evaluate inflation protection

- Consider how insulated your income is from inflation
- Insulated: Working income (usually), Social Security, government pensions
- Not insulated: Interest on fixed-rate investments, private corp pensions

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Step 7: Evaluate inflation protection

- Best sources of inflation protection for portfolio include the following:
  - Inflation-protected bonds (TIPS, I-Bonds)
  - Stocks, especially wide moats with pricing power
  - Real estate, commodities
  - Bank-loan investments, high yield bonds

Step 8: Review individual positions

- Morningstar Ratings and Analyst Reports enable you to quickly review the status of current holdings.
- For funds, red flags include:
  - Ratings, manager, strategy changes
  - Persistent underperformance vs. cheap index fund
- For stocks, red flags include:
  - High price/fair value, low star rating
  - Negative moat trend

Step 9: Formulate an action plan

- De-risking especially important for people in or near retirement
- De-risking also important for other goals that are close at hand
- Need to make changes? Watch out for taxes
  - Concentrate changes in tax-sheltered accounts
  - If subject to RMDs, pull RMDs from overweight positions
  - Taxable accounts: Add new money to underweight positions versus selling overweight ones

Step 9: Formulate an action plan

- Other to-dos for 2022 include:
  - Take advantage of higher contributions for 401(k)s, HSAs
  - Take advantage of backdoor (while you can)
  - Assess appropriateness of IRA conversions

- Questions? Comments?
- Christine.benz@morningstar.com

Thank you for watching

Still have questions? Email us at
the.shortanswer@morningstar.com

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