5 Portfolio Pitfalls and How to Fix Them

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November 2022

Morningstar's Portfolio Makeover Week

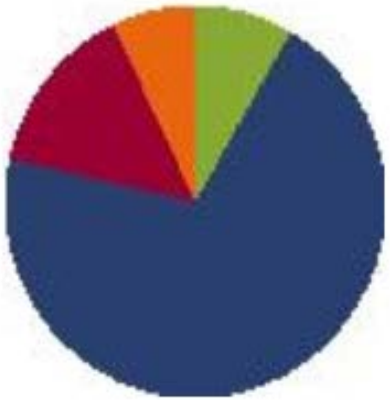
- Have been conducting since 2011
- Key goals
  - Showcase portfolios and common issues for real-life investors
  - Discuss investments in the context of actual financial plans
  - Use Morningstar tools and analytics to make assessments
  - Inspire investors to evaluate and improve their own portfolios

5 Portfolio Pitfalls I'll Be Discussing Today

- A too-aggressive asset allocation prior to retirement
- Overspending in retirement
- Lack of diversification, including
  - Too-light international exposure
  - Growth biases
  - No inflation protection
- Portfolio sprawl
- Tax inefficiencies

Pitfall 1: A Too-Aggressive Asset Allocation Prior to Retirement

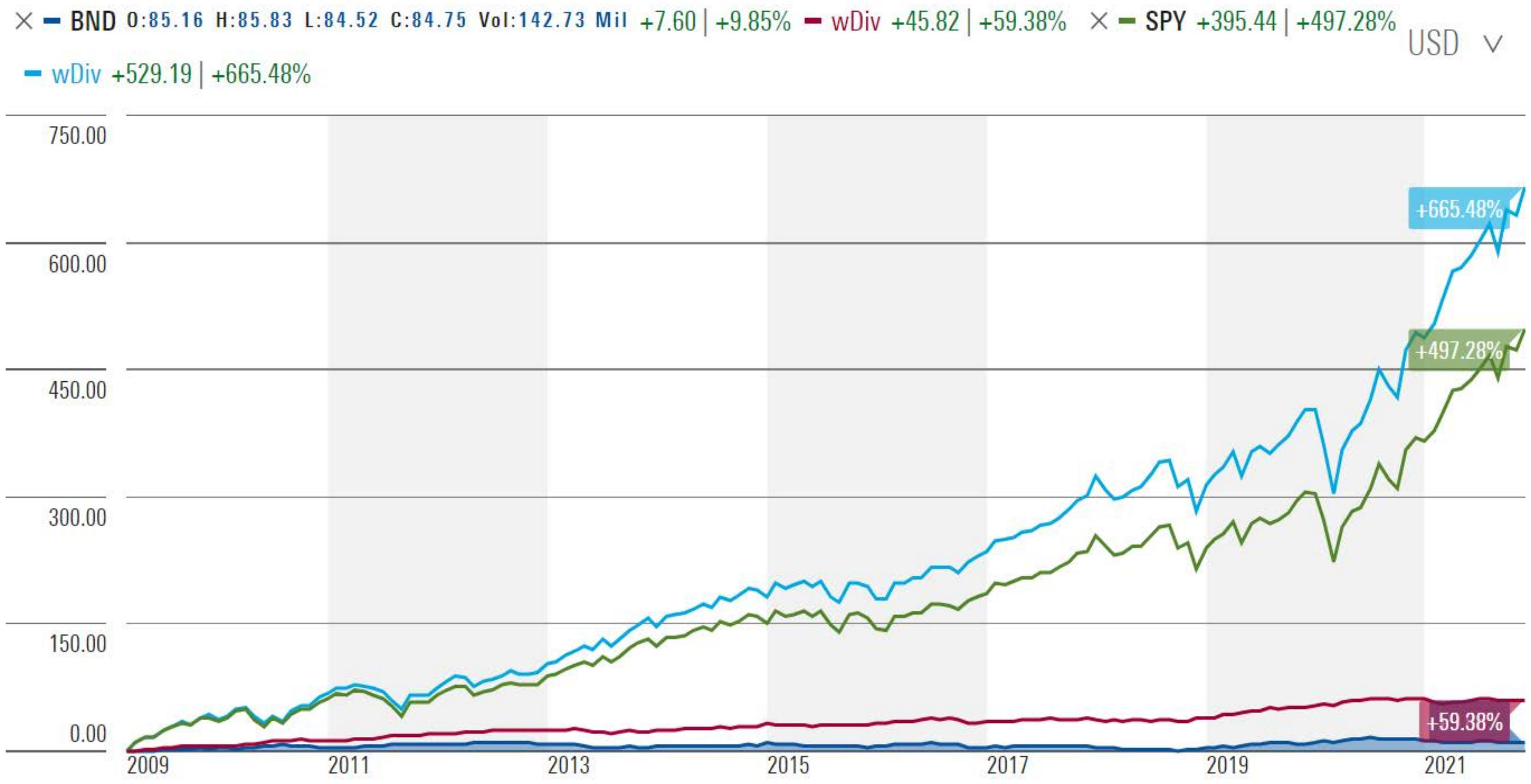
Asset Allocation | Holdings Detail



	Long%	Short%	Net%
Cash	8	0	8
U.S. Stocks	70	0	70
Foreign Stocks	14	0	14
Bonds	7	0	7
Other	0	0	0
Not Classified	0	0	0
Total	**100**	**0**	**100**

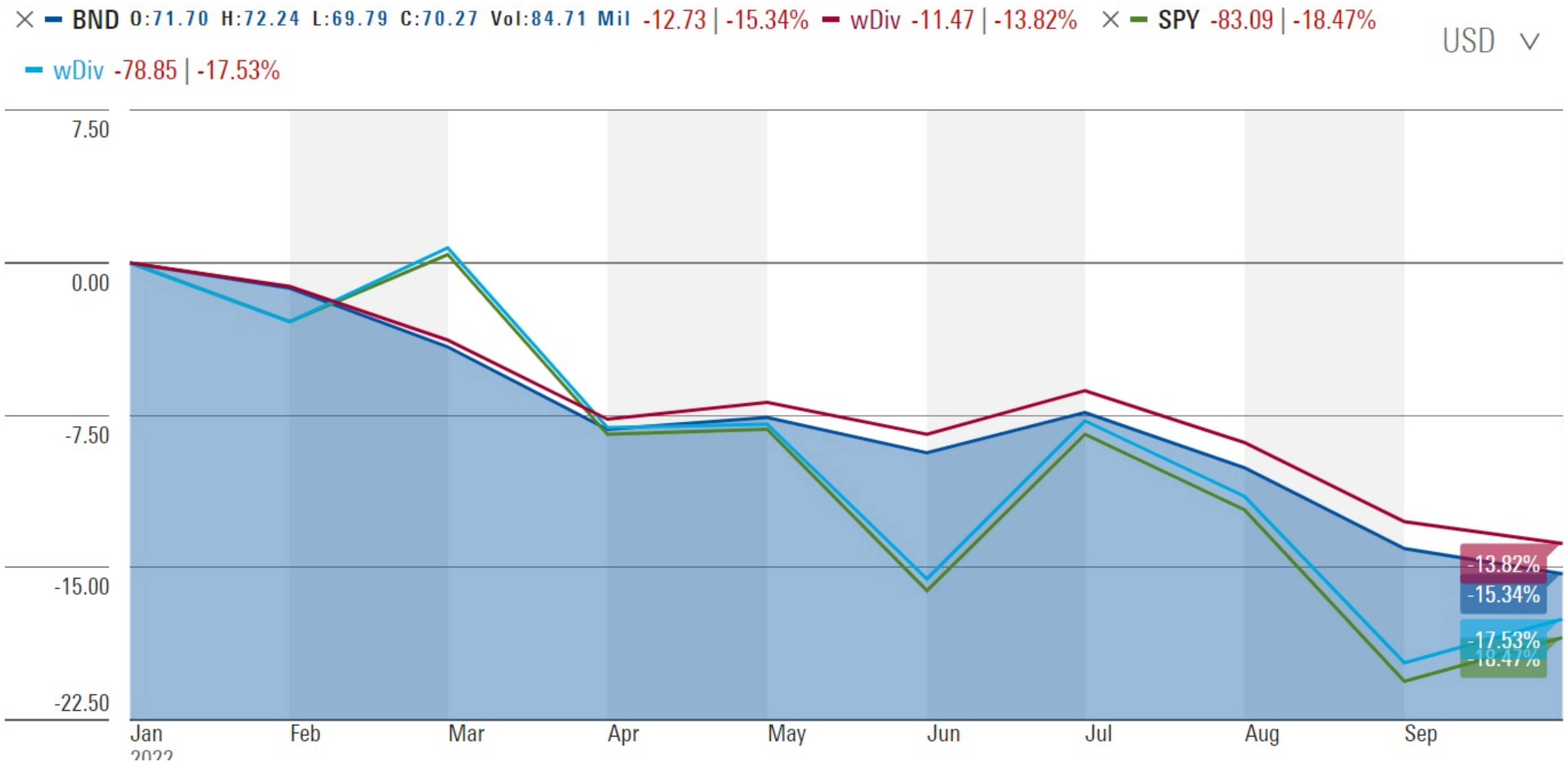
Source: Morningstar.com Portfolio X-Ray.

History Shows Why Investors Often Let Equities Ride



Source: Morningstar.com, BND v. SPY, 03/09/09-12/31/22.

Both Asset Classes Have Been Poor in 2022



Source: Morningstar.com, BND v. SPY, 1/3/22-10/17/22.

Where Would Such a Retiree Go for Cash in 2022?

- $700,000: Vanguard Total Stock Market –22.87%
- $50,000: Vanguard Total Bond Market –15.67%
- $50,000: Cash +2%-3%
- $100,000: Vanguard Total International Stock Market: -25.56%

But what happens when that cash position is gone?

Source: Morningstar.com, 10/17/22.

Bucket Approach Helps Provide In-Retirement Spending

Bucket 1

For: Years 1 and 2

Holds: Cash

Goal: Fund Near-Team 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: Stocks

Goal: Growth

Sample ETF Bucket Portfolio: $30K/y spending

Bucket 1: Liquidity Portfolio for Years 1 and 2: $60,000
$60,000 in CDs, money market accounts/funds, other cash

Bucket 2: Intermediate Portfolio for Years 3-10: $240,000
$50,000 in Vanguard Short-Term Bond ETF BSV

$75,000 in Vanguard Short-Term Inflation-Protected Securities VTIP

$115,000 in iShares Core US Bond Market IUSB

Bucket 3: Growth Portfolio for Years 11 and Beyond: $450,000
$175,000 in Vanguard Dividend Appreciation VIG

$110,000 in Vanguard Total Stock Market Index VTI

$125,000 in Vanguard FTSE All-World ex-US VEU

$40,000 in Vanguard High-Yield Corporate VWEHX

Bonds Have Been Disappointing YTD But History Looks Better

Bonds as Buffer: Frequency and Magnitude of Losses

Quarterly losses since 1926	Stocks*	Bonds**
# of negative periods	120	101
% of negative periods	31	26.1
Average magnitude of loss (%)	-7.81	-2.01
Annual losses since 1926	**Stocks**	**Bonds**
# of negative periods	25	15
% of negative periods	26	15.6
Average magnitude of loss (%)	-13.2	-2.4

Source: Morningstar Direct, Sept. 30, 2022.

No Shame in De-Risking Now If You Need To

- U.S. stocks
  - 1-year return: -18.98
  - 3-year return: 8.26%
  - 5-year return: 8.79%
  - 10-year return: 11.46%
  - 15-year return: 8.08%

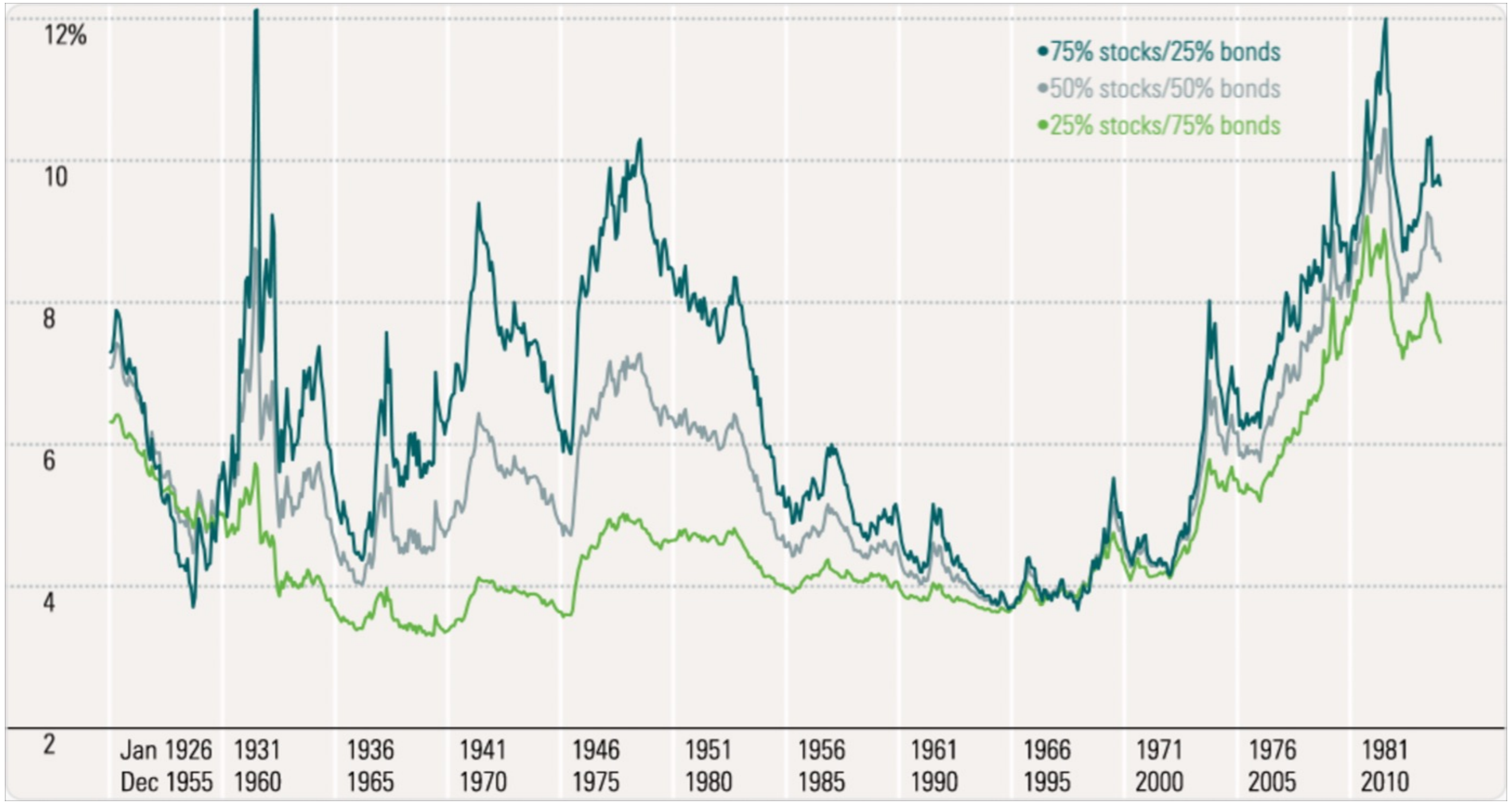
Tips If You're De-Risking in Pre-Retirement Years

- Maximize non-portfolio income sources first
- Mind tax consequences; concentrate selling equities in tax-sheltered accounts
- Bear in mind withdrawal sequencing: Taxable assets often first in spending queue
- *Gradually* de-risk in years leading up to retirement
- Mind inflation, opportunity costs when adding safe assets
  - Don't overdo it!

Pitfall 2: Overspending in Retirement

- Setting an in-retirement spending rate is hard because it rests on several unknowables
  - How long you'll live
  - How the market will perform
  - What inflation will run
  - Whether you'll encounter expenses outside your control (big home repair, uninsured long-term care expenses, etc.)

The 'Right' Withdrawal Rate Depends on Your Era



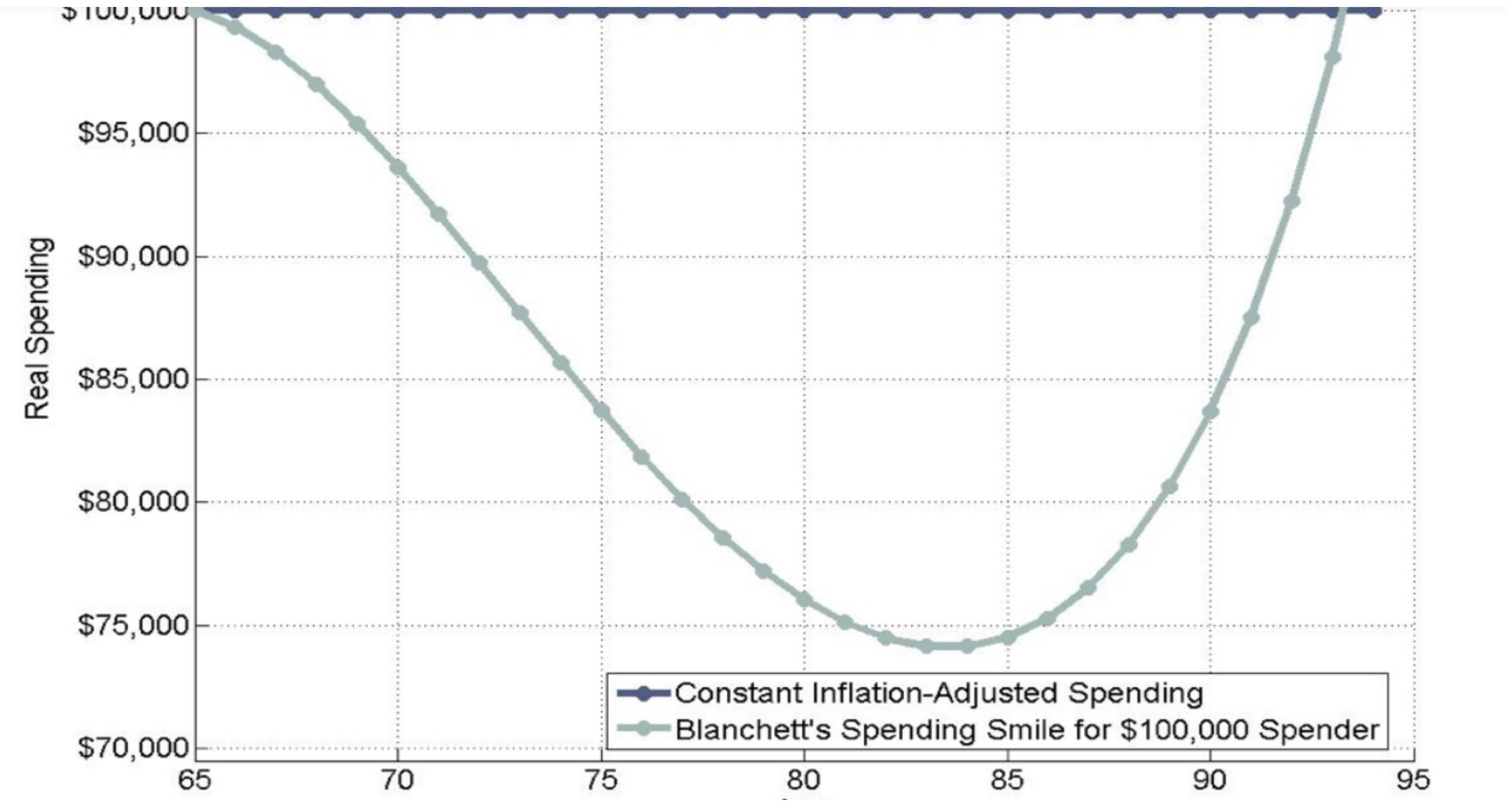
4% Guideline a Starting Point

- Does not mean 4% of balance year in and year out
- Assumes a 4% starting withdrawal with annual dollar amount inflation adjusted thereafter
  - e.g., $40,000 on a $1 mil. portfolio in year 1 of retirement
  - $41,200 in year 2 (assuming 3% inflation)
- Delivers a stable standard of living in retirement
- Stress-tested over many different market environments

4% Guideline: The Caveats

- Market history is all we have but the future could look different
  - If it's worse over your 25- or 30-year time horizon, you risk overspending and having to cut back later in life
  - If it's better: You'll have underspent relative to what you might have
- The big caveat: Retirees don't actually spend this way

Retirement Spending Smile



Source: Retirement Researcher, https://retirementresearcher.com/retirement-spending-smile/

Setting Your Retirement Spending Rate: Flexibility Pays

- Adjusting withdrawals in line with portfolio performance can help in two ways:
  - You take less when your balance is down, leaving more in place to recover when markets do
  - You can take more when it's up, enlarging lifetime withdrawals
- The big caveat: Downward adjustments may not be welcome, especially when inflation is high and/or in early retirement

Pitfall 3: Lack of Diversification

- Most common diversification issues I see
  - Too little in safe assets after age 50 (already covered)
  - Too-light international exposure
  - Growth biases
  - No inflation protection

Source: Morningstar Markets Observer

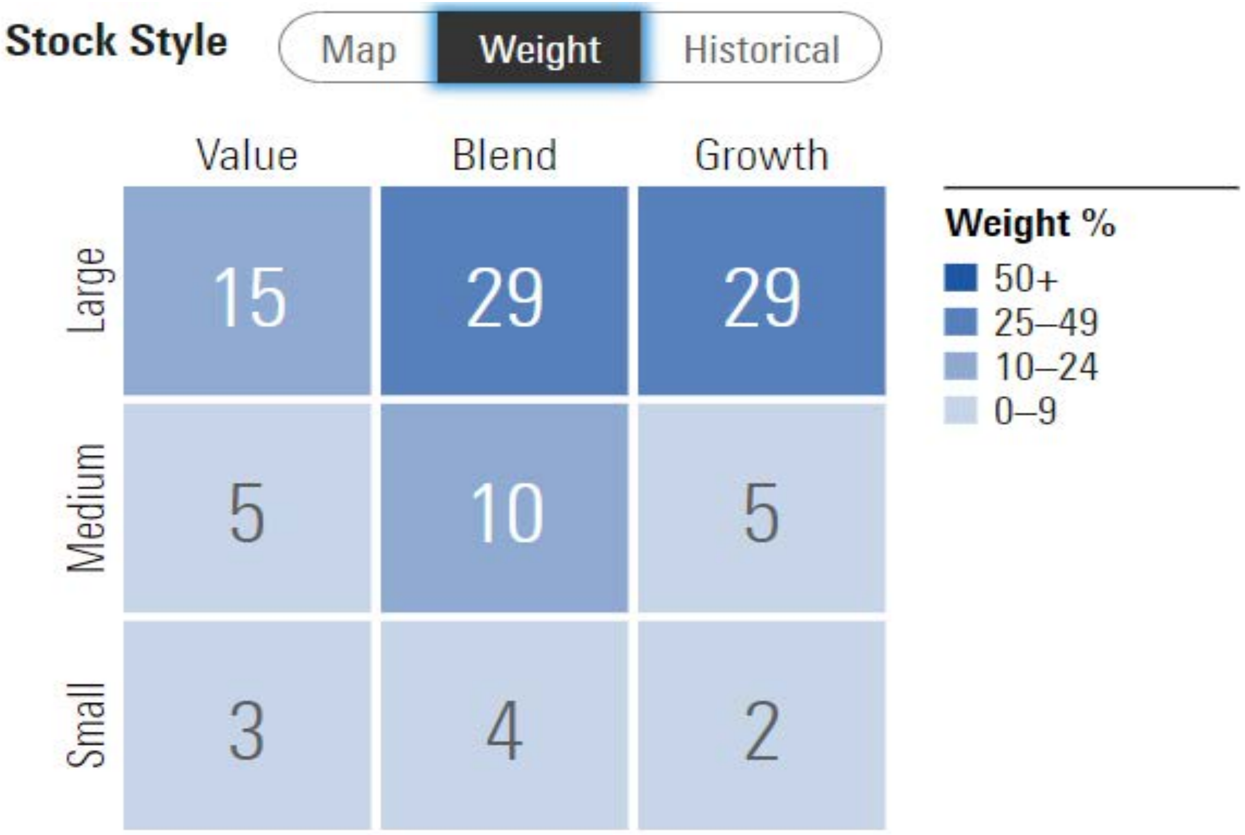
U.S. Growth Stocks: It's Been a Great Run

Source: Morningstar.com, Vanguard Growth Index (VUG) v. Vanguard Value Index (VTV), 1/31/04-10/17/22.

U.S. Stocks Have Also Thumped Non-U.S.

Source: Morningstar.com, Vanguard Total Stock Market v. Vanguard Total International Stock, 1/31/11-10/17/22.

Time to Revisit Growth v. Value Exposure in Your Port



U.S. v. Non-U.S., Too

- Global market capitalization a starting point
  - 60% U.S.
  - 40% non-U.S. today
- Target-date funds another good benchmark
  - Average 2060 fund: 64% U.S./36% non-U.S. (of equity %)
  - Average 2025 fund: 68% U.S./32% non-U.S. (of equity %)
- Most U.S. investors' non-U.S. weightings aren't that high

Another Missing Piece in Many Portfolios: Inflation Protection

- For long-term inflation protection
  - Stocks
  - Commodities (maybe...)
  - Real estate/ real estate equities

- For purchasing power protection in drawdown mode
  - I-bonds
  - Treasury Inflation-Protected Securities (esp. S/T)
  - TIPS about 25% of fixed-income weighting in retirement income funds

Pitfall 4: Portfolio Sprawl

- Holdings have a way of stacking up
  - Multiple employer plans
  - Two spouses with separate accounts
  - Investment hobbyists/collectors

- Why it's a problem
  - Can obscure the big picture: Asset allocation
  - More holdings = more oversight

Pitfall 4: Portfolio Sprawl: How to Fix It

- Consolidate like accounts
  - Old 401(k)s--> Single IRA
  - Multiple rollover IRAs--> Single IRA
  - Multiple brokerage account--> Single brokerage account
- Reduce # of holdings within those accounts by employing well-diversified building blocks
  - Broad market index funds and exchange-traded funds
  - All-in-one funds
- Mind tax consequences if selling long-held positions from taxable account

Pitfall 5: Tax Inefficiencies

- Frequently spotted tax issues
  - High-income producers in taxable accounts
  - Active equity funds in taxable accounts
  - All-in-one funds in taxable accounts
  - Insufficient liquidity in accounts that will be early in retirement withdrawals

How to Improve a Portfolio's Tax Efficiency

- Take advantage of tax-sheltered receptacles: IRAs, 401(k)s, HSAs, 529s
- Concentrate tax-inefficient assets in tax-sheltered accounts
  - High-income stocks and bonds
  - Funds that trade a lot (e.g., active equity)
  - Funds that rebalance back to a target

Source: Morningstar Markets Observer

How to Improve a Portfolio's Tax Efficiency (More)

- Within taxable accounts emphasize:
  - Index funds, ETFs, individual stocks for equity exposure
  - Municipal bonds if need bond exposure in taxable account and in a high tax bracket
- Pay attention to cost basis when repositioning
- In retirement:
  - Develop a year-by-year plan for withdrawal sequencing
  - Consider conversions, accelerated trad IRA withdrawals in post-retirement pre-RMD years
  - Get help!

Thank you for watching

Still have questions?
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