



How To Build A Low Risk Portfolio (Asset Allocation 201)

“But divide your investments among many places, for you do not know what risks might lie ahead.”
Ecclesiastes 11:2 (NLT)

This is a good lesson for investors whose primary goals are preservation of wealth in real terms and low fluctuations in the total market value of their investments. It may be a good fit for those already wealthy or in retirement. But it should also be helpful in some way for anyone looking to become a better investor.

When I wrote the first [lesson on Asset Allocation](#), I noted that “wealthy people may think in terms of commodities, precious metals, private equity, direct real estate holdings, etc.” I thought it would make sense to explore the reasons behind that fact. The primary reason is that if your goal is to preserve wealth in real terms (i.e. inflation adjusted terms), while minimizing volatility, it makes sense to diversify across as many asset classes as possible.

Background On Investment Risk, Expected Return, Beta, Correlation, and Diversification

Investment risk can be thought of in many different ways. Various types of securities carry different types of risk. One of the primary measures of risk is volatility of market value. Volatility refers to the level of either past or expected future fluctuations in market price. For a stock, we might use past volatility of a particular stock as a proxy for future volatility. You will often see mention of [Beta](#), which is a measure of an individual stock’s volatility relative to the market. So, stocks that have a Beta of 1 have moved with the market. Stocks that have a Beta less than 1 have fluctuated less than the market. Stocks that have a Beta greater than 1 have fluctuated more than the market. With bonds, it does not make sense to use past volatility as a proxy for expected future volatility. There are actually better ways to build an expectation for volatility in a bond portfolio, but that will have to wait for a future lesson on fixed income. The main point here is that pretty much all investments carry some risk that the market value will fluctuate while we’re holding them. That risk is known as volatility.

Some investors do not want to see the market value of their total portfolio go down by a large amount in a short period of time. So, even though stocks may offer the best real returns over long periods, investors who don’t want to run the risk of watching the total value of their investments drop up to 40%

in a single year may decide to allocate money elsewhere. This is known as diversification. Diversification works as long as the market values of asset classes do not move completely in tandem with each other.

This introduces a concept known as correlation. Please bear with me if this is new terminology that makes you feel like you're back in college. I promise, it's not that hard to understand and it's very important. It will make you a better investor to understand correlation.

The most common measure used to determine the degree to which two variable's movements are associated with each other is the correlation coefficient. The correlation coefficient ranges from -1 to 1. If two variables, such as the percentage return of stocks and the percentage return of gold, has a correlation coefficient of -1, they are said to be perfectly negatively correlated. In other words, if stocks go up 10%, gold should go down 10%. Get it? See, that wasn't hard.

Conversely, if the two variables have a correlation coefficient of 1, they are said to be perfectly correlated. In that case, if stocks go up 10%, gold should go up 10%. If stocks go down 10%, gold should go down 10%. They move together in perfect tandem. Obviously, there is no diversification benefit from owning two different asset classes that are perfectly correlated with one another.

That brings me to a very important point. Asset classes do not have to be negatively correlated in order to provide a diversification benefit.

They just have to be *less than perfectly correlated*.

Here is the other big key:

No two major asset classes are perfectly correlated.

So, adding new asset classes to your portfolio always provides some diversification benefit. That's why you can expect to minimize volatility in your portfolio by spreading your investments over as many asset classes as possible.

So, why am I not recommending that everyone do this? Because there's another very important aspect to investing: expected return. I can lower expected volatility, but it probably comes at the expense of some amount of expected return. Obviously the lowest volatility asset classes also offer the lowest returns (think savings accounts and CDs). As I've mentioned previously, I don't know of any major asset class that has a higher expected return over long periods of time than U.S. stocks. Historically, there just isn't anything which beats U.S. stocks over long periods. But, they don't go up in a straight line. They fluctuate wildly at times. That means that they are in one very real sense, a high risk asset class. The shorter the time horizon for the equity portion of your portfolio, the more at risk that portion is considered to be. If I had \$100,000 that I was planning to use for some purpose (purchase a home, start a business, fund a charity, etc.) 1 year from now, I would not put any of it in the stock market. It should go into a savings account, CD, money market fund, commercial paper, or T-bills because those investments carry extremely low risk of loss over the stated time period. But they also offer very low returns. This principle is pretty easy to understand and can be extrapolated to larger time periods and broader scenarios.

Why Take Above Average Risk When You've Already Achieved Your Goals?

There is a line of thinking which says, "You only have to get rich once." What people mean is that once you have saved and invested enough, sold a lucrative business in order to retire, won the lottery, etc. and amassed enough wealth to reach your goals, why continue to risk it in order to generate excess money that you don't need in the first place? If I were retiring today with \$2 million, would I really need to be fully invested in stocks so that when I die I have potentially maximized my wealth? Or, should my goal be to generate a small return in real terms, hedge inflation risk, and have a portfolio that doesn't fluctuate in value by say more than 10% in a single year? The latter employs wisdom and restraint. It seems very prudent. The former might be driven by greed, or maybe even a "love of money". Granted, it may also be driven by a desire to maximize the giving I am able to do as I leave this world. Like anything, it comes down to motives. Even if I were planning to give it all away, it may not be wise to continue to risk the wealth I've been given, especially since I don't know *when* I will leave this world.

A Portfolio That Maximizes Diversification Benefits

To me, it makes a lot of sense for retirees and wealthy people to consider the type of portfolio I'm about to outline. But there are all kinds of reasons why people may consider more concentrated portfolios. I've mentioned before that those who have just enough retirement money to get by should consider a portfolio made up mostly of long term corporate bonds. It all depends on your situation, your needs, your goals, your motives, your emotional risk tolerance, etc. For those whose goal it is to generate a reasonable real return, hedge inflation risk, generate a small percentage of income, preserve the wealth they've amassed, and have the peace of mind that comes from low volatility, they may want to consider a broad asset allocation that looks something like this:

5% U.S. Stocks

5% International Developed Stocks

5% Emerging Market Stocks

5% TIPS (Treasury Inflation Protected Securities)

10% Municipal Bonds

5% Treasury Bonds

5% U.S. Investment Grade Corporate bonds

5% U.S. High Yield Bonds

3% International Sovereign Bonds

7% International Developed Market Bonds

5% International Emerging Market Bonds

10% Precious Metals

10% Commodities

10% Real Estate

5% Private Equity

5% Alternative Investments (e.g. Hedge Funds or other Long/Short Funds)

This type of portfolio would probably generate a small real return (averaging somewhere between 2-4%), with relatively low expected downside in any given year (normally falling somewhere between 2-6% for years in which it is down, with maximum expected downside of probably 8-12%), and some natural level of inflation hedge. This type of portfolio does not maximize return over the long term. It also invests in asset classes that have different rationales behind them, and are used for different purposes by investors.

For example, it's obvious to anyone who has spent a significant amount of time on this site that I personally prefer dividend paying stocks. There are so many advantages to them. But, I'm 36 years old. My time horizon is very long. So the rational approach for me right now is to accept higher volatility in order to maximize my long term expected return by investing in stocks. My common sense, along with historical evidence, tells me that it is wise and prudent to invest primarily in stocks that pay me money to hold them *and* should significantly increase in value over the long term. Investing in commodities or precious metals is a different game. Buying a basket of commodities (or a security that is backed by a basket of commodities) provides an inflation hedge. In other words, as the government prints more money, I can expect that a basket of commodities should rise in value accordingly. Of course, each individual commodity is driven by various supply and demand conditions in the marketplace. But, I think the case for investing in commodities is as an inflation hedge over the long term, and for diversification benefits. Anything beyond that is simply price speculation.

Investing in precious metals may hedge some currency and inflation risk, while also providing a diversification benefit. They are also seen as a safety net in the case that we have a breakdown of civilized society or modern economic systems. In that case, you would want to own the physical metals themselves. Shares of [GLD](#) wouldn't do you much good under such a scenario.

Those are just a couple of quick examples from the outlined portfolio. Maybe I can explore the ins and outs of various asset classes in future lessons. For now, I just wanted to note that there is rationale behind my personal preferences (just like there is rationale behind various other asset classes). There are reasons why I have a newsletter that is designed to identify attractive dividend paying stocks, as opposed to say, trying to identify and highlight the best ETF for all of the asset classes listed above.

Personal preferences aside, there is definitely wisdom in this type of approach. Ecclesiastes 11 contains wisdom for investors (though you may have to read one of the more modern translations such as the NLT before that becomes obvious). The New Living Translation of Ecclesiastes 11:2 says, "But divide your investments among many places, for you do not know what risks might lie ahead." A more literal translation of that verse from the New American Standard version says, "Give a portion to seven, or even to eight, for you know not what disaster may happen on earth." I have seen some Christians use the literal translation to make the case that we should divide our investments among 7-8 different asset classes. While I don't think they are necessarily wrong to interpret it that way, I don't personally interpret it that way. I interpret the verse to indicate simply that diversification is a wise principle for investors to employ.

While this scripture may not seem groundbreaking and poignant for the non-Christian, Christians should consider the instruction to be significant. This passage indicates that we shouldn't make large "bets" or expect God to simply bless whatever "investment strategy" we choose to pursue. At another point (in Ecclesiastes 9:1), Solomon says, "This, too, I carefully explored: Even though the actions of the godly and wise people are in God's hands, no one knows whether God will show them favor." (NLT) So, we should employ wisdom and ask for God's blessings, while realizing that it is never fully guaranteed. In other words, Christians face uncertainty and risk just like everyone else. But, [wisdom can be rationally expected to help us succeed](#).

So, my conclusion after a good bit of study, reflection, and prayer, was that Christians should work hard at their investing activities, incorporating biblical wisdom and planning. But we should also incorporate man's wisdom to the extent it is helpful in following biblical instruction. There is plenty of man's wisdom out there which runs counter to biblical wisdom. You have to decide for yourself which strategies and techniques are in keeping with biblical instruction. This website is designed to help in that regard.

One way or another, we have to make our best effort when investing to [do it well](#). That includes proper planning, using wisdom and restraint, employing patience, avoiding actions that are driven by negative emotion, being honest, generous, and productive. More pertinent to this discussion, we are instructed to practice awareness, mitigation, and management of risk. This is all explored in more detail in our [Free Report: What Every Christian Investor Needs To Know](#).

Suffice it to say, wise investing can be fairly easy once you've put in the thought and work required to understand investments and plan properly. Indeed, the whole point of passive investments is to allow your money to work for you. But investing is not something that just magically happens. It requires a good bit of initial [study](#), [hard work](#), and [planning](#). Further, wise investing is not a [get rich quick scheme](#), or akin to [chasing a fantasy](#). It requires [discipline](#), [patience](#), [self-control](#), and [wisdom](#) to [make the right investments](#) and [monitor them](#) over many years. But it [can also be enjoyable](#) and [rewarding](#).

The bottom line on asset allocation is that you have to employ wisdom in building a plan that is tailored to your individual situation. The type of approach outlined in this lesson may not be appropriate for 30 year olds trying to meet retirement goals. It may be very appropriate for those who have already achieved their financial goals. Whatever your situation, this lesson hopefully has been helpful in some way for anyone looking to become a better investor.

Appendix A: Implementation

I am including an Appendix here that demonstrates a fairly easy and low cost way to implement the approach outlined in this lesson. The *easiest* way to implement the approach would be to find a knowledgeable, honest financial planner to construct a portfolio for you. The problem, as always, is the expense associated with doing so destroys a lot of the benefit to such a portfolio.

If the financial planner charges 1% annually to "manage" your portfolio, they are taking probably 25-33% of the real return you're expecting to get from this strategy. If you can rationally expect from this mix of assets, real returns of 3-4% (before fees and expenses) to live on and spend for yourself, you're giving up an awful lot of that real return to the advisor in order to do something that you can probably do on your own. Further, you have to remember that advisors typically want to place you into investment products that carry their own high fees and expenses. This can potentially eat up another

25-50% of your real expected return. Now, you're only keeping 1-2% in real annual returns for yourself. I'm not making this up people.

Fortunately, there is a much cheaper way, at least for most of the asset classes listed above. If I were going to try to implement this type of strategy, I would simply open accounts with various discount brokers (many ETFs have a least one discount broker that allows their fund to be traded commission free) and allocate my funds as follows:

Weight	Asset Class	Name of Fund	Ticker	Strategy	Style	Exp. Ratio
7.50%	U.S. Stocks	Vanguard Total Stock Market ETF	VTI	Tracks the CRSP US Total Market Index	Passive	0.05%
7.50%	Intl Developed Stocks	Vanguard FTSE Developed Markets ETF	VEA	Tracks the FTSE Developed ex North America Index	Passive	0.10%
7.50%	Intl Emerging Mkt Stocks	Vanguard FTSE Emerging Markets ETF	VWO	Tracks the FTSE Emerging Index	Passive	0.15%
5.00%	TIPS	Vanguard Short-Term Inflation Protected Securities ETF	VTIP	Tracks Barclays U.S. TIPS 0-5 Year Index	Passive	0.10%
10.00%	Municipal Bonds	Market Vectors Intermediate Muni Index ETF	ITM	Tracks Barclays AMT-Free Int. Muni Index	Passive	0.24%
5.00%	U.S. Treasury Bonds	iShares 7-10 Year Treasury Bond ETF	IEF	Tracks Barclays U.S. 7-10 Year Treasury Bond Index	Passive	0.15%
5.00%	U.S. Investment Grade Corporate Bonds	Vanguard Intermediate Term Corporate Bond ETF	VCIT	Tracks Barclays US 5-10 Year Corporate Bond Index	Passive	0.12%
5.00%	U.S. High Yield Bonds	iShares Baa - Ba Corporate Bond Fund	QLTB	Tracks Barclays US Baa - Ba Capped Index	Passive	0.30%
3.00%	International Sovereign Bonds	iShares S&P/Citigroup International Treasury Bond Fund	IGOV	Tracks S&P/Citigroup International Treasury Bond Index Ex-US	Passive	0.35%
7.00%	International Developed Market Corporate Bonds	Vanguard Total International Bond ETF	BNDX	Tracks Barclays Global Aggregate ex-USD Float Adjusted RIC Capped Index (USD Hedged)	Passive	0.20%
5.00%	International Emerging Market Bonds	Market Vectors Emerging Markets Local Currency Bond ETF	EMLC	Tracks JPM GBI-EMG Core Index	Passive	0.47%
5.00%	Precious Metals (Gold)	iShares COMEX Gold Trust	IAU	Backed by physical gold and intended to track day to day price of gold bullion	Passive	0.25%
5.00%	Precious Metals (Silver)	ETFS Physical Silver Shares	SIVR	Backed by physical silver and intended to track day to day price of silver bullion	Passive	0.30%
10.00%	Commodities	UBS DJ-UBS Commodity Index Total Return ETN	DJCI	Tracks DJ-UBS Commodity Index Total Return	Passive	0.50%
12.50%	Real Estate	Vanguard REIT ETF	VNQ	Tracks MSCI US REIT Index	Passive	0.10%
0.00%	Hedge Funds/Other Alternatives	No good ETF options at present				
0.00%	Private Equity	No good ETF options at present				

Voila, like magic, you have an extremely well-diversified portfolio with a weighted average expense ratio of .218%.

There are a few items worth noting. There are ETFs which market themselves as Private Equity ETFs, but they actually invest in publicly traded companies that hold private equity investments, such as Business Development Companies. I did not find any that appeared to me to be viable options for gaining exposure to Private Equity like returns. Many BDCs hold primarily debt issued to private firms, in addition to having some equity. If you really wanted exposure to BDCs, it might be best to buy them directly, as a lot of specialty ETFs have vague strategies and carry high fees and expenses. The other thing is that BDCs alone do not represent a very well understood or documented asset class. I have studied some individual BDCs that make pretty compelling cases as attractive investments. But there just isn't enough history there to truly understand the diversification benefit of BDCs as a separate asset class.

As well, there are ETFs which market themselves with the words "Hedge" in the name, or with names that include common hedge fund strategies such as "merger arbitrage", for example. These are not investments in hedge funds. They are attempts to generate "hedge fund like returns" using publicly traded securities, futures contracts, etc. Some of them appear to hold nothing but long and short positions in other ETFs. The bottom line on this is, private equity and hedge fund exposure would mean more diversification and lower overall volatility. But since it is almost impossible for the average investor to achieve such exposure at this point in time, I would simply reallocate that targeted portion of my portfolio back to other asset classes, as a practical measure, until there becomes a good, viable, low cost way to gain exposure.

A few further notes:

- Personally, I find it difficult to think, philosophically, of silver and gold as investments. I tend to philosophically classify them as stores of value, or in the short term, only as price speculation. You're basically buying hunks of metal that sit in a vault and you have to pay someone to store them. When you buy them, you're only doing so in the hopes of the price going up. Gold and silver are used in jewelry and industrial uses, but the price is primarily driven by "investor" demand. In other words, it is driven by the fact that people do or don't want to park their money there, which is normally driven by their view of whether or not the prices of the metals will be going up or down. The "fundamentals" behind gold and silver as "investments" is difficult to wrap your mind around. All you can really do is compare the price of gold to say, the value of a dollar, or to some other commodity such as oil that is driven by actual supply and demand fundamentals. Still, the point of this exercise is to build a low risk, well-diversified portfolio, and precious metals will offer returns that are different from stocks, bonds, and cash. There will be times where they strongly outperform the stock market. In that sense, they definitely have a place in this type of investment strategy.
- Commodities are driven by supply and demand, which changes with economic activity, as well as with the supply of money. So in some sense, they are an inflation hedge. But there will be times when the commodities basket is going down in value, whereas there are almost never times in which the CPI goes down. So, they are very imperfect as an inflation hedge, but they do work well over long enough periods to hedge inflation. The other issue is that investors are not getting direct exposure to commodities. They are tracking the price movements of commodities

through taking long positions in the corresponding futures contracts, and then continuing to roll into new long positions as the old contracts expire and are settled. While imperfect, this method should closely track actual price changes in commodities.

- With silver and gold ETFs, the trust actually owns the physical silver and gold. It generally never leaves the custodians' vaults where it's held, but it does actually get rebooked under the new owner's name when it's purchased by the trust. In some instances, it even gets moved around from one place to another (with specific little rooms or shelves being set aside and labeled for specific owners) inside the vault. But generally, investors in gold and silver ETFs cannot take physical delivery of the gold and silver. So, if you can't take physical delivery, is it a safe haven? No, it isn't. If you want a true "safe haven" (Is there such a thing?), you need to own physical gold and silver that is in your own hands. If you want the diversification benefits of an asset that will track price movements of precious metals in a normal world, the ETFs work just fine.
- REITs are a decent option for gaining exposure to real estate. However, they are not the same as holding direct real estate investments. In fact, most investment professionals think of REITs as a separate asset class from direct real estate. But REITs do have lower overall volatility and low correlation to large cap U.S. stocks (though they are more highly correlated than direct real estate), thus offering significant diversification benefits, as well as being an asset class that generates regular cash payments and is backed by hard assets. Personally, I really like REITs as a fundamentally sound investment vehicle. I hope to maybe write more lessons or even offer a separate newsletter one day that is all about REITs. But for now, I just wanted to highlight a few benefits. The Vanguard REIT ETF is basically a way to get indirect exposure to commercial real estate without having the headaches associated with owning real estate directly.
- For municipal bond exposure, investors can also look for state specific municipal bond funds in order to save on their state income tax bill. The option I have shown here provides both the diversification benefits of having exposure to municipal bonds as an asset class, as well as saving on federal income taxes from interest income. However, there are [mutual funds available](#) that have slightly lower expense ratios than the muni bond ETF I've listed here. This table was meant to show readers how easy it is to build a low cost, low risk portfolio using ETFs.

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